

# Notes and Comments

## A Case Study of the Impact of Consumer Legislation: The Elimination of Negotiability and the Cooling-Off Period\*

Since the promulgation of the Uniform Commercial Code in 1952, the American economy has been revolutionized by an enormous growth in consumer credit.<sup>1</sup> Responding to this growth, the National Conference of Commissioners on Uniform State Laws in 1968 proposed a new code—the Uniform Consumer Credit Code (UCCC)—to deal with problems of consumer law largely ignored by the UCC.<sup>2</sup>

Two widely acclaimed provisions of the UCCC are the proposed restriction on the use of negotiable notes in consumer transactions<sup>3</sup> and the three-day cooling-off period for home solicitation sales.<sup>4</sup> Un-

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1. In December 1952 outstanding consumer credit totaled \$25.8 billion, and consumer installment credit totaled \$18.7 billion. 39 FED. RES. BULL. 1214 (1953). By November 1968 these two figures had jumped to \$110.0 and \$88.0 billion respectively. 55 FED. RES. BULL. A-52 (1969). The amount of the outstanding consumer installment credit in repair and modernization loans (the subject of this study, see pp. 622-23 *infra*) was \$1.4 billion in December 1952, 39 FED. RES. BULL. 1214 (1953), and \$3.9 billion in November, 1968. 55 FED. RES. BULL. A-52 (1969).

2. The Uniform Commercial Code [hereinafter cited as UCC] was not drafted to cover the consumer law field comprehensively, but it does apply to consumer goods in the absence of a special state statute. See UCC § 9-101, Comment: "Consumer installment sales and consumer loans present special problems of a nature which makes special regulation of them inappropriate in a general commercial codification. Many states now regulate such loans and sales under small loan acts, retail installment selling acts and the like. While this Comment applies generally to security interests in consumer goods, it is not designed to supersede such regulatory legislation."

3. UNIFORM CONSUMER CREDIT CODE §§ 2.403, 2.404, Alternatives A & B [hereinafter cited as UCCC]. See pp. 635-36 *infra*. The first official version of the UCC denied third parties freedom from defenses in consumer sales. UCC § 9-206 (1952 version). See also Note, *Consumer Sales Financing: Placing the Risk for Defective Goods*, 102 U. PA. L. REV. 782 (1954). This provision was later altered to allow third parties freedom from defenses unless the enacting state had a different statute or decision for consumer goods. UCC § 9-206. This change was made under heavy pressure from the banking lobby. Kripke, *Consumer Credit Regulation: A Creditor-Oriented Viewpoint*, 68 COLUM. L. REV. 445, 470 (1968). In some states the proposed UCCC provisions have come under a similar attack and this threatens the defeat of the new Code altogether.

4. UCCC § 2.502.

certainty about the impact of the restriction on negotiability, in particular, is a major obstacle to the enactment of the new Code. While the problems with which these provisions are concerned have been much noted and analyzed,<sup>5</sup> no empirical studies have been made of the impact on financiers, sellers, and consumers of existing statutes which contain similar provisions.<sup>6</sup> In order to provide data relevant to an evaluation of the probable impact of the UCCC, the *Journal* has made an empirical study of the home improvement business in Connecticut and the effects of certain provisions of the Connecticut Home Solicitation Sales Act of 1967.<sup>7</sup> The Act provides that (1) buyers have a right to cancel a home solicitation sale before midnight of the first business day after signing the contract, and (2) the obligation to pay arising from a home solicitation sale cannot be evidenced by a negotiable instrument.<sup>8</sup>

5. For discussions of negotiability in consumer transactions, see Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1093 (1954); Jones, *Finance Companies as Holders in Due Course of Consumer Paper*, 1958 WASH. U.L.Q. 177; Jordan & Warren, *The Uniform Consumer Credit Code*, 68 COLUM. L. REV. 387 (1963); Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 S. CAL. L. REV. 48 (1966); Murphy, *Another "Assault Upon the Citadel": Limiting the Use of Negotiable Notes and Waiver of Defense Clauses in Consumer Sales*, 29 OHIO ST. L.J. 667 (1968); Vernon, *Priorities, the Uniform Commercial Code and Consumer Financing*, 4 B.C. IND. & COM. L. REV. 531, 542 (1963); Comment, *Negotiable Instruments Law—"Close Connexity" and the Finance Company as a Holder in Due Course*, 18 LA. L. REV. 322 (1958); Note, *Finance Companies and Banks as Holders in Due Course of Consumer Installment Credit Paper*, 55 NW. U. L. REV. 389 (1960).

For discussions of cooling-off periods, see Sher, *The "Cooling-Off" Period in Door-to-Door Sales*, 15 U.C.L.A.L. REV. 717 (1968); Note, *Consumer Protection: The Proposed Cooling-Off Period*, 2 VAL. L. REV. 339 (1968).

6. There have been a few empirical studies of consumer credit in general and of specific problems raised by consumer credit. E.g., BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, *CONSUMER INSTALLMENT CREDIT* (1957); D. CAPLOVITZ, *THE POOR PAY MORE* (1963); Project, *Resort to the Legal Process in Collecting Debts from High Risk Credit Buyers in Los Angeles—Alternative Methods for Allocating Present Costs*, 14 U.C.L.A.L. REV. 879 (1967).

The few empirical studies have been overshadowed by the massive outpouring of general studies of consumer problems. E.g., *Consumer Credit, A Symposium*, 8 B.C. IND. & COM. L. REV. 387 (1967); *Symposium on Consumer Protection*, 64 MICH. L. REV. 1197 (1966); *Consumer Credit Symposium*, 55 NW. U.L. REV. 301 (1960); *Consumer Protection Symposium*, 29 OHIO ST. L.J. 593 (1968).

7. CONN. GEN. STAT. § 42-134 to -143 (Supp. 1968) (P.A. 749) [hereinafter cited by section numbers: §§ 134-143]. The Act was passed July 6, 1967 and took effect October 1, 1967.

8. The Act makes two other changes in the law which were not included in our study. First, Section 135 requires a notice on the contract informing the buyer of certain statutory rights. These include information about the cooling-off period, and about the buyer's rights to a copy of the agreement, to pay off the full unpaid balance at any time, and to bar the seller from unlawfully entering his premises. Second, Section 140 prohibits what are commonly known as "referral sales": the seller offers the buyer a special deal and in return the buyer gives the names of prospective purchasers to the seller. For a description of the fraud inherent in such a plan, see *State ex rel. Lefkowitz v. ITM, Inc.*, 52 Misc. 2d 39, 275 N.Y.S.2d 303 (Sup. Ct. 1966); *Norman v. World Wide Distributors Inc.*, 202 Pa. Super. 53, 195 A.2d 115 (1963); Comment, *Translating Sympathy for Deceived Consumers into Effective Programs for Protection*, 114 U. PA. L. REV. 395, 397-403 (1966).

This Comment begins by discussing methodology and the sources used in the study. A description of the essential characteristics of the home improvement business in Connecticut is followed by an analysis of the effect of the one-day cooling-off period provided for by the Connecticut Act. The bulk of the Comment is concerned with the impact of the elimination of negotiability on financial institutions, dealers, and consumers.

## I. Methodology

In investigating the consequences of the Connecticut Act, questionnaires<sup>9</sup> were sent in August 1968 to all Connecticut banks with total assets of \$25,000,000 or more,<sup>10</sup> to all sales finance companies registered with the Connecticut Bank Commissioner, and to 249 home solicitation dealers. To prepare the questionnaires and then to supplement the responses to them, interviews<sup>11</sup> were conducted through the spring and fall of 1968 with a wide range of persons associated with the door-to-door sales business—dealers, dealers' association representatives, distributors, bank and finance company officials, lawyers, and lobbyists.

Several facts should be considered as possibly limiting the validity of the findings of this study: (1) the names of dealers solicited had to be taken from only five sources; (2) completed questionnaires were returned by less than one-third of the dealers and sales finance companies contacted; (3) the findings present the result of only one year's experience since the passage of the Act; (4) the study focuses on the home improvement business.

*Source of dealer names.* Attempts to find dealers through the phone book indicated that the only reliable way to get names was from organizations which had direct experience with numbers of dealers. Three volume banks, one large finance company, and one dealer trade association supplied the names of more than 500 Connecticut dealers. Questionnaires were sent to a little more than half of these.

9. The dealer questionnaire is fully set out in the Appendix *infra*.

10. Banks with assets of more than \$25 million control over 90 per cent of the total bank assets in Connecticut. See BANK COMMISSIONER OF THE STATE OF CONNECTICUT, 1967 ANNUAL REPORT 64-65, 174-78 (1968). In interviews with dealers and bank officials, we learned of no banks purchasing dealer paper to which we did not send a questionnaire. These sources did not feel that smaller banks are significantly involved in the home improvement field.

11. Responses to questionnaires and the interviews were conditioned on an agreement that the identity of the respondents not be disclosed. Consequently, certain viewpoints presented in this study can be attributed only generally (for example, "a Connecticut banker").

Using this limited number of sources left open the possibility that the dealers studied would be unlike the average door-to-door dealer in some material respect. Three considerations, however, indicate that the sample is representative. First, the source institutions are large and geographically comprehensive. Second, the detailed responses from the banks revealed that not many more than 500 dealers in Connecticut use institutional financing. Third, a computer table program proved that the dealers identified by no single source varied consistently in their responses from the other dealers in the sample.<sup>12</sup>

*Questionnaire response percentages.* The findings on Connecticut banks are based on the responses of all twenty-six to which we sent questionnaires. Complete findings were secured by phoning the thirteen banks who had not responded to either of our two mailings.

The statistics on door-to-door sellers are based on the responses of 51 dealers—or roughly one-fifth of the 249 to whom questionnaires were sent.<sup>13</sup> The dealer sample may not be perfectly representative; any subgroup which voluntarily takes the time and has the candor to respond to a questionnaire may differ from the average in some material way.<sup>14</sup> In this case, it may be expected that those who responded have more clerical assistance, have a greater sense of civic responsibility, or are more concerned about the Act than the general population of door-to-door dealers. To some extent the biases these characteristics cause may cancel each other out—for example, the results of this study indicate that those dealers with clerical help and those injured by and thus most concerned about the Act are different classes of dealers, with conflicting assessments of the worth of the Act.<sup>15</sup>

In addition, independent checks were made on the validity of the dealer responses. The bank and finance company reports, for example, covered much of the same ground. Likewise, interviews with distributors—the dealers' suppliers—yielded the views of another group with

12. The table program cross-references each answer (e.g., yes, no, no response) in the dealer questionnaire with each other answer. The results of the cross-tabulation indicated the patterns of dealer responses: for example, we could determine how many dealers answered question three with a "yes," and then find out how these dealers answered question 14.

13. We sent 269 questionnaires, but eleven were returned "address unknown" and nine were duplicates sent mistakenly to dealers already contacted. Responses were received from 80. Twenty-one of these stated that they either made no door-to-door sales or did not use institutional financing; seven returned incomplete questionnaires; one was received too late to include in the study.

14. See generally G. SJOBERG & R. NETT, *A METHODOLOGY FOR SOCIAL RESEARCH* 154 (1968). For a critique of the Kinsey Report on this basis, see W. COCHRAN, F. MOSTELLER & J. TUKEY, *STATISTICAL PROBLEMS OF THE KINSEY REPORT* 52 (1954).

15. See pp. 647-49 *infra*.

inside knowledge of dealers and wide contacts among them. To verify reports of serious injury, all dealers alleged to have gone out of business were called.<sup>16</sup> Furthermore, a computer table program isolated subgroups of the sample to determine whether the trends found were true of most dealers or whether they were true only of certain identifiable subgroups and not of others.

Although returns were received from all banks, less than one-quarter<sup>17</sup> of the sales finance companies to which questionnaires were sent responded. However, this low rate of return is neither surprising nor a serious flaw in the study because finance companies play a very small role in financing door-to-door home improvement transactions.<sup>18</sup>

*Timing of the study.* The Act was passed by the Connecticut legislature on July 6, 1967. Financiers in the next months debated and decided what policy they would follow when the Act became effective on October 1. Some banks and finance companies which withdrew from dealer financing in the fall of 1967 reevaluated their decisions as experience under the Act accumulated in the next months and readjusted in the spring of 1968 by adopting more liberal financing standards. Whether this trend will continue subsequent to the findings of this study, which reflect the state of business as of the end of September 1968, is difficult to estimate. So far, however, the readjustments since the initial banking changes in July 1967 seem to have been confined to smaller volume banks and finance companies and have not been so marked as to appreciably affect the general availability of credit or the general validity of the findings of this study.

*The Home Improvement Business.* The study is limited to sale of home improvement products and services for three reasons. First, the Connecticut Act, like certain other state acts,<sup>19</sup> seems to have been

16. See Appendix, Dealer Questionnaire, question 20. Phone responses from dealers alleged to have gone out of business were of course not included among the 51 dealers in our statistical sample.

17. Twenty of Connecticut's 88 sales finance companies responded to our request.

18. In this study, for example, not one responding dealer indicated that he financed exclusively with sales finance companies. Similarly, of the 20 sales finance companies which responded to our questionnaire, only three presently handle dealer paper and two of the three are only slightly involved with four and two dealers respectively.

Our findings of relatively slight finance company involvement in Connecticut is confirmed at the national level by federal reserve statistics: At the end of November 1968 commercial banks held \$2,723,000,000 in repair and modernization loans, while sales finance companies held \$74,000,000, about 2.6 per cent of the bank total. 55 FED. RES. BULL. A-53 (1969).

19. See, e.g., the earliest cooling-off period statutes, PA. STAT. ANN., tit. 73, § 500-202 (c)(4) (Supp. 1969), MICH. COMP. LAWS ANN. § 445.1202 (1967), which are limited in scope to "home improvement installment contracts."

aimed primarily at this business.<sup>20</sup> Second, this category appears to constitute the great majority of door-to-door sales financed by banks in Connecticut.<sup>21</sup> Third, home improvements represent a discrete field of business suitable for empirical study.

## II. A Description of the Home Improvement Business and its Financing

One of the primary aims of this study was to determine business and financing practices in the home improvement business in Connecticut.<sup>22</sup> The following description is based on reports from dealers and their financing agencies.

Home improvement is a loose term which encompasses many different types of businesses.<sup>23</sup> It includes both (a) general maintenance and repair work—such as replacement of broken windows, plumbing and heating, roofing and siding, painting and plastering,<sup>24</sup> and (b) major alterations or additions—such as swimming pools, air conditioning, fencing, new kitchens, and paved driveways.<sup>25</sup> Although some home improvement dealers work as general contractors and will accept any work relating to the home, most specialize in one of the above categories.

The Connecticut home improvement business has not attracted new dealers in recent years,<sup>26</sup> and many existing firms have not grown in size.<sup>27</sup> While some sellers are large enterprises with many employees,

20. Interviews with home improvement dealer and financing agency lobbyist, spring 1968.

21. Interviews with Connecticut bank officials, spring and fall 1968.

22. For descriptions and analyses of home solicitation sales, see Sher, *supra* note 4, and a project study now underway by the *U.C.L.A. Law Review*. For a description of the home improvement business, see Comment, *Legislative Solution to a Judicial Dilemma: The Pennsylvania Home Improvement Finance Act*, 10 VILL. L. REV. 309 (1965). For descriptions of consumer installment sales financing, see B. CURRAN, *TRENDS IN CONSUMER CREDIT LEGISLATION* 5-14 (1965); Jones, *supra* note 5, at 177-180.

23. The categories used here were derived from the dealers' responses to the question: "What is your main line of business?"

24. This category included 25 of 40 respondents. This type of work will be referred to in this article as "general repair" work.

25. This category included 15 of 40 respondents. This type of work will be referred to as "major alterations or additions."

26. No responses came from dealers who had entered the business within the past year; only five had been in the business less than five years; 19 had been in the business six to 15 years; and 26 had been operating more than 15 years. This might indicate a high failure rate among new dealers.

27. Eleven of the dealers who have been operating over 15 years are one or two-man concerns. See note 123 *infra*.

many are either one-man concerns or very small firms with just a few salesmen.<sup>28</sup>

Home improvement dealers operate in one or more of the following ways: the dealer solicits door-to-door and completes the entire transaction in the buyer's home; the dealer calls or receives calls from potential customers and then visits the home where the contract is signed; the dealer visits the home prior to the buyer's agreement to the contract, but the contract is completed at the seller's office; the entire transaction is completed at the seller's place of business.<sup>29</sup> The first method and probably the second are within the definition of home solicitation in the Connecticut Act.<sup>30</sup>

28. Fifteen of the dealers worked alone; five consisted of one head of business and one full time canvasser; and 31 were larger.

29. We asked the following question about sales technique: "In what manner are your sales made? (a) You or your employee(s) go door-to-door, find people who are interested in making purchases, and sign the contract at their homes. (b) You or your employee(s) receive calls or visits from people interested in making purchases and you then visit them in their homes and sign the contracts there. (c) You receive calls and visit homes, but sign the contracts at your place of business. (d) People come to your place of business and the sale is concluded there without any visit to the customer's home."

For convenience, these categories will be referred to as (a) straight door-to-door, (b) phone-home, (c) home-business-contract, (d) business-contract. The following table indicates the breakdown of sales techniques of the 51 responding dealers:

SALES METHODS EMPLOYED BY RESPONDING DEALERS  
(By Number of Dealers)

Sales Method	0	Percentage of Respondent's Sales In Which Method Employed			100%
		25%	50%	75%	
Straight Door-to-Door	31	8	2	5	5
Phone-Home	12	8	11	13	7
Home-Business-Contract	30	11	6	2	2
Business-Contract	35	10	4	1	1

It should be noted that there is an ambiguity as to which question covers the business practice where the dealer solicits by phone and the contract is signed in the home. We have assumed that this practice falls mainly under the phone-home method, despite the emphasis in the straight door-to-door category on dealer initiative. This decision was based on a spot check of dealers who had responded to the questionnaires.

30. A "home solicitation" sale is defined in Section 134 as a "sale of goods and services in which the seller or his representative solicits the sale and the buyer's agreement or offer to purchase is made at a home other than that of the person soliciting the same . . . ." This section has not been interpreted by the Connecticut courts, and it is likely that there will be a legal dispute over the definition of "solicit." Does it cover, for example, the situation in which the buyer makes a preliminary phone call but the sale is not completed until the seller visits the home? And does advertising constitute solicitation? Arguably the Act was not designed to cover anyone except the passive buyer who takes no initiative at all until confronted by the seller, and a strict reading of "solicit" would reach this result. Still, the Act's requirement that the contract be signed away from the seller's home, or place of business, is a clearer standard which would avoid definitional haggling. Financing agencies have partially resolved the ambiguity by lumping everything vaguely resembling a home solicitation sale into that category; and they have gone even further by generally treating all of a particular dealer's sales as home

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After the contract is signed the seller often goes to a distributor and purchases the goods or materials he needs to complete the contract. The dealer may either pay the distributor on a job-by-job basis or arrange for a line of credit. If the dealer needs workmen, he may be able to hire some at the distributor's office;<sup>31</sup> otherwise he completes the work himself or with his own workmen.

Interlacing the process of solicitation, sale, obtaining materials, and doing the work is the question of financing. In most situations the buyer is either unwilling or unable to pay cash and some form of credit must be arranged.<sup>32</sup> The seller, however, may need cash immediately for personal reasons or in order to get the materials; or he may be reluctant to carry the administrative burdens of long-term installment contracts.<sup>33</sup> Furthermore, dealers of any size may make a greater profit from immediate reinvestment of proceeds in their business than they do from interest on outstanding debt. Since both parties desire to make a contract, the financing difficulties are worked out by resorting to a third party for assistance, and financial institutions play this role.<sup>34</sup>

solicitation if any part of his business can be so labeled. Interviews with bank officials, spring 1968. *See also* Littlefield, *The Home Solicitation Sales Act of 1967*, 42 CONN. B.J. 436, 437-39 (1968).

31. Interviews with dealers, spring 1968.

32. Thirty-one of 48 responding dealers noted that prior to the Act over 25 per cent of their retail sales were installment credit sales, and the average response of the 48 dealers was close to 50 per cent. This figure for home solicitation sales is comparable with the estimates of 25 per cent as the ratio of installment credit to retail sales for consumer goods as a whole. Brunn, *Wage Garnishment in California*, 53 CALIF. L. REV. 1214, 1241 n.146 (1965).

33. For a discussion of the importance of installment credit for the consumer, see C. PHELPS, *FINANCING THE INSTALLMENT PURCHASES OF THE AMERICAN FAMILY* (1954); for the importance to the dealer, see C. PHELPS, *INSTALLMENT SALES FINANCING: ITS SERVICES TO THE DEALER* (1953).

34. The terms "financing agency," "financer," and "financial institution" are used in this study to refer to all financial institutions which are somehow involved in financing the home solicitation business. Banks handle most of the home improvement financing in Connecticut. Thirty-six of the responding dealers work exclusively with banks and all respondents dealt with at least one bank. *See* note 18 *supra*.

Commercial banks are the principal financers of home improvement sales; savings banks in Connecticut are not allowed by law to purchase dealer paper, and their involvement is therefore limited to direct loans to customers. *See* Letter from Connecticut Bank Commissioner to the chief executive officers of each savings bank in Connecticut, July 3, 1967, on file in the Yale Law Library, interpreting CONN. GEN. STAT. § 36-97a (Supp. 1968). Nationally, savings banks and savings and loan associations "typically have preferred longer term loans and investments and generally have not sought actively to acquire a large share of repair and modernization loans." AMERICAN BANKERS ASSOCIATION, *THE COMMERCIAL BANKING INDUSTRY* 176-77 (1962).

Sales finance companies finance retail installment contracts, but they are not significantly involved in home improvement financing. *See* note 18 *supra*. Financing with a sales finance company tends to be more expensive than financing with a commercial bank, since the cost of money is higher for finance companies than for banks. *See generally* W. PLUMMER & R. YOUNG, *SALES FINANCE COMPANIES AND THEIR CREDIT PRACTICES* 61 (1940).



The need for financial assistance has resulted in several different financing arrangements involving the financier, the dealer, and the buyer. The major distinction is between "indirect" and "direct" loans. A direct loan involves only the financial institution and the buyer; the buyer goes to the financing agency and takes out a loan in his own name.<sup>35</sup> An indirect loan, on the other hand, involves in the first

For a statistical study of sales finance companies and their operations, see 53 FED. RES. BULL. 534 (1967).

Small loan companies cannot purchase consumer paper from dealers, cannot make loans of over \$1,000, and in most instances cannot give secured loans. See CONN. GEN. STAT. § 36-225 to -243 (Supp. 1969). For these reasons they are not significantly involved in the home improvement business. For a statistical study of small loan companies, see 53 FED. RES. BULL. 534 (1967).

There is some indication that the Act will cause distributors to make loans and enter the finance business for their dealer-customers who have had trouble obtaining financing from the traditional sources. Interview with dealer, fall 1968. At present, distributors generally extend open account credit for 30, 60, or 90 days. Although financing dealer sales would provide interest from the beginning of the credit extension, it seems likely that the burdens to the distributor of carrying the long-term debt would in turn raise costs for dealers and consumers.

Federal Housing Administration insurance of home improvement loans is available to commercial lenders under Title I of the National Housing Act. 12 U.S.C.A. § 1703 (1969). To be eligible the principal of the loan must be less than \$5,000 and the term must be longer than six months and less than five years and 32 days. 12 U.S.C.A. § 1703(b) (1969). Regulations promulgated under the Act limit financing charges to a maximum of \$5 per \$100 original face amount per year for the first \$2,500 and to \$4 per \$100 of face amount per year in excess of \$2,500. 24 C.F.R. § 201.4(a) (1968). Additional charges such as recording fees and insurance premiums are narrowly restricted. 24 C.F.R. § 201.4 (b)-(d) (1968). The loans may be with or without security. 24 C.F.R. § 201.5(b) (1968). Although reserve accounts are prohibited, a dealer may be required to indorse or guarantee the full amount of the loan. 24 C.F.R. § 201.4(c) (1968). The proceeds of the loan may "be used only to finance alterations, repairs, and improvements . . . which substantially protect or improve the basic livability or utility of the property." 24 C.F.R. § 201.6(b) (1968). See generally CURRAN, *supra* note 22, at 60-65, 75-76; CONN. GEN. STAT. § 36-178(j) (Supp. 1969) (savings and loan associations authorized to make home improvement loans insured under Title I). Federal insurance is not at present an important aspect of the home improvement loan business because the current yield is far below market rates.

35. The definition and legal implications of a direct loan are complicated by Section 134 which states: "A sale which otherwise meets the definition of a home solicitation sale except that it is a cash sale shall be deemed to be a home solicitation sale if the seller . . . assists in obtaining a loan for the buyer to pay the purchase price." This provision applies, for instance, when the dealer recommends that a buyer go to Bank "X" to obtain a loan with which to pay the purchase price, and in return for the recommendation the bank gives the dealer some special benefit. Prior to the Act, 16 dealers financed some of their sales in this fashion.

The Act clearly subjects sales financed in this way to the notice provisions of Section 136 and to the cooling-off period provisions of Section 135, but there is some doubt as to the effect of the elimination of negotiable notes in Section 138. Some banks believe that direct loans given on the recommendation or with the assistance of the seller are now subject to the buyer's contract defenses. Interview with bank official, fall 1968. These banks are therefore hesitant to make loans on dealer recommendations, although this study showed a drop of only 3 dealers in the number that financed some sales in this fashion. Without legislation, case law in some jurisdictions already endangered the financing agency's holder in due course status in this situation. Cf., e.g., *Commercial Credit Corp. v. Orange County Mach. Works*, 34 Cal. 2d 766, 214 P.2d 819 (1950). But it does not seem that the Act does this itself, since Section 138 states that "[a]ny transfer of a note

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instance only the buyer and the seller. The buyer signs a note along with the sales contract promising to pay the price in installments. The seller then sells the note to the financing agency, which collects the installments from the buyer as they fall due. The financier has effectively made a loan to the buyer, paying the proceeds directly to the seller; the loan is then repaid in installments.

In making indirect loans, banks often do business only with a certain list of dealers,<sup>36</sup> and they supply these dealers with a package of forms—blank note forms, completion certificates, and traditional credit applications—to be used in each credit sale. When the contract is signed, the buyer normally signs a note providing for installment payments and completes a credit application. The dealer forwards the credit application to the bank, which then decides whether to grant its approval to the indirect loan. Usually approval is granted as a matter of course to dealers who work regularly with the bank.<sup>37</sup> When the work is completed, the buyer executes a completion certificate.<sup>38</sup> The dealer then presents the completion certificate to the bank and negotiates the

or other evidence of indebtedness . . . shall be deemed an assignment only . . ." (emphasis added), and a direct loan, however obtained, does not require a *transfer* of a note or debt.

It might be contended that all direct loans should be subject to consumer defenses when the financier knows that the purpose of the loan is to purchase consumer goods. See generally Kripke, *supra* note 3, at 470-71 n.66. Such a rule would raise serious doubts about a bank's protection when its credit card is used to pay the purchase price of a consumer good. See generally UCCC § 3.106(3); Bergsten, *Credit Cards—A prelude to the Cashless Society*, 8 B.C. IND. & COM. L. REV. 485, 509-17; *Bank Credit Cards and the Uniform Commercial Code*, 1 VAL. L. REV. 218, 242-43 (1967).

36. Before providing a dealer with indirect financing, most banks require that he submit an application with information concerning his business and credit standing. See p. 638 *infra*.

37. The credit application is helpful in case of default to inform the financier of the nature and amount of the buyer's assets.

38. Completion certificates are forms signed by the buyer which state that the work under a specific contract has been completed to his satisfaction. The certificates are theoretically signed after the work is completed. Banks require that they be signed before financing is finally approved. All lenders seeking FHA insurance, see note 34 *supra*, must obtain completion certificates from their borrowers. See generally 24 C.F.R. § 201.8(a)(2) (1968).

It is widely believed that prior to the Act completion certificates were useless as a protective device. Sellers would fraudulently sign the forms themselves or buyers would sign them prior to the completion of work as a necessary condition to the seller's willingness to help arrange financing. See generally MASS. ANN. LAWS ch. 255D, § 9A (1965) (certificates signed by buyer prior to completion are invalid). The dealer needed the money before he could complete the work, the buyer wanted the work done, and the banks—protected by holder in due course status—had no interest in further inquiry. Banks have been more attentive since the Act, and in an attempt to cut down on misuse of the certificates at least one bank now issues individual completion certificates only after each indirect loan has been tentatively approved. Interview with bank official, spring 1969.

For the effect of completion certificates on holder in due course status, see *International Fin. Corp. v. Rieger*, 272 Minn. 192, 137 N.W.2d 172 (1969) (finance company that supplied certificate forms held apprised of actual conditions of sale and not a holder in due course).

note. Often the entire transaction is completed with one trip to the bank, as the credit application, note, and completion certificate may all be signed by the buyer at the same time.

### III. Impact of the Connecticut Act: The Cooling-Off Period

In response to the high pressure and fraudulent sales techniques of some home solicitation dealers and the typical passivity of home solicitation buyers,<sup>39</sup> many states have enacted legislation providing a "cooling-off" period.<sup>40</sup> This type of provision gives the buyer the right to cancel a contract within a short period of time after the completion of the sale. The purpose of these statutes is to provide a decompression period during which the buyer can shop around and reconsider the purchase out of the seller's presence.

The Connecticut Act allows the buyer to cancel before midnight of the first business day after the contract is signed.<sup>41</sup> One firm conclusion of this study is that a cooling-off period of such short length benefits consumers very little. Only seven dealers responded that customers had used this provision, and only two of those indicated that it had been used more than three times since the law went into effect. This

39. For a number of reasons home solicitation sales are a matter of special consumer concern. First, the sales practices of door-to-door sellers tend to involve high-pressure and often fraudulent tactics. See Sher, *supra* note 4, at 721-25. Second, the consumer is more likely to be taken by high-pressure tactics or fraud in his home than he is in the salesroom. In the former case he is psychologically unprepared to evaluate objectively the sales pitch whereas if he ventures out to the salesroom he has shown his "self-inspired" interest. *Id.* 725-26. Finally, as an explanation but not a justification for the separate treatment of door-to-door sellers, the sellers affected by these laws are simply not as politically powerful as the larger retail establishments.

40. In most states these statutes are limited to home solicitation sales. *E.g.*, GA. CODE ANN. § 96-906 (Supp. 1968); ILL. ANN. STAT. ch. 121½, § 262B (Smith-Hurd Supp. 1969); MASS. ANN. LAWS ch. 255D, § 14 (1968); WASH. REV. CODE ANN. § 63.14.010(2)(c) (Supp. 1968). See also MICH. COMP. LAWS ANN. § 445.1202(c) (1968); PA. STAT. ANN. tit. 73, § 500-202(c)(4) (Purdon Supp. 1969) (both limited to home improvement sales). But see VT. STAT. ANN. tit. 9, § 2454 (Supp. 1968) (all retail installment sales). The new federal Truth-in-Lending Act, effective July 1, 1969, provides for a three-business-day "cooling-off period" in consumer credit transactions in which a security interest in the consumer's residence is taken. 15 U.S.C.A. § 1635 (Supp. 1969).

41. § 135. It should be noted that Section 135 provides the buyer with a one-day cooling-off period "[i]n addition to any right otherwise to revoke an offer." In many transactions the salesman is not able to make a firm offer to sell, and the seller's acceptance of the buyer's offer to purchase is conditioned on the approval by the salesman's main office. In large home improvement contracts it seems particularly likely that the seller would reserve to himself the opportunity to check the credit of the buyer before final acceptance. In such a situation the buyer at common law would have the right to cancel the contract any time prior to home-office acceptance. Without the "in addition" provision quoted above, a cooling-off period statute might be construed as cutting off the buyer's other cancellation rights by turning his offer to purchase into an irrevocable firm offer after one day. See generally UCC 2-205. UCCC § 2.502 also contains a clause saving the buyers' common law cancellation rights.

conclusion is further corroborated by Legal Aid lawyers who say that since the Act was passed they have had no clients seek advice within the cooling-off period.<sup>42</sup>

This marginal benefit to the consumers may be balanced against an almost total lack of harm to dealers and financing agencies. The financing agencies simply delay approval of credit until after the period has lapsed. The dealers report little difficulty with the provision, and only three dealers stated that they lost buyers to competitors who undersold them—the main fear of the businessmen prior to the Act.<sup>43</sup> In fact, dealers may use the right to cancel as part of the sales pitch to lower the buyer's resistance to the sale.

Several factors explain the limited value of the one-day cooling-off period. First, 40 dealers, about 90 per cent of those responding, stated that before the Act they allowed customers to cancel sales already concluded.<sup>44</sup> If this is true, the statute simply brought the law into line with existing business practices. Second, although notice of the buyer's right to cancel must be printed on the contract, the seller does not have to inform the buyer orally of his rights.<sup>45</sup> About half of the dealers reported that they did so inform their buyers, but it is likely that many buyers never know they have the right to cancel.<sup>46</sup> Third, and most

42. Interviews with staff attorneys, New Haven Legal Assistance Association, Inc., New Haven, Conn., January 1969.

43. One dealer reported 18 cancellations stating that competitors used his "contract to negotiate a lower price deal after we had done the groundwork advertising, sales, etc." Another reported six cancellations worth \$14,200 caused by "unethical competitors offering purported better but phony terms and prices."

44. Thirty-seven dealers stated that they allowed cancellation as long as they had not begun work on the job, and five reported that they allowed cancellation within one day (there is undoubtedly an overlap between these two groups). These conclusions contrast markedly with comments by legal aid lawyers that the retailers with whom they have dealt never permit cancellation. Interview with lawyers at New Haven Legal Assistance Association, Inc., New Haven, Conn., January 1969. Our findings are partially explained by the time lag in certain cases between the consumer's "offer" to purchase and the "acceptance" by the dealer's front office. See note 41 *supra*.

Nine of 36 responding dealers stated that they charged a penalty for cancellation. Of course before the salesman receives home-office approval the dealer would have no legal claim to a penalty, and this is still the case under the Act. See § 138(c): "If the buyer avoids the sale on any ground independent of his right to cancel [under this Act], the seller is not entitled to retain a cancellation fee." But, for cancellations authorized only by the cooling-off provisions, the Act allows the dealer to "retain as a cancellation fee five per cent of the cash price, fifteen dollars or the amount of the down payment, whichever is less." § 138(c). UCCC § 2504 provides a cancellation fee of "5 per cent of the cash price but not exceeding the amount of the cash down payment."

45. For a fuller discussion of disclosure problems, see Sher, *supra* note 4, at 760.

46. One dealer capsulized his business ethics on this point as follows: "I always remember the story of the young ensign who was called to be a witness in a naval case who asked his uncle, an admiral, how he should conduct himself on the witness stand. The uncle said he should conduct himself like an officer of the U.S. Navy: square his shoulders, answer questions with humility and respectfulness, but under no circumstances get up there and blurt out the truth."

important, the period is simply too short to have a substantial effect.<sup>47</sup> Most buyers do not reconsider a contract until after the goods are received or the services are performed. These events will usually not occur within a day of the sale, especially since the sellers know that the contract may be cancelled in that time.

The UCCC provides a three-day cooling-off period,<sup>48</sup> but this marginal increase is not likely to have a major effect on consumers or dealers. A substantially longer period, on the other hand, would severely impede the sales and financing process. Home improvement dealers would not make repairs until the period had run, since the value of their services would not be easily recoverable if the buyer rescinded the contract. And financing agencies would wait out the period before extending credit, thereby cutting off the sellers' funds. Furthermore, since most buyers are not motivated to cancel until they see some evidence of the work or feel the impact of the financing plan, even a longer period might not successfully protect consumers.

#### IV. Impact of the Connecticut Act: The Elimination of Negotiability

When a financing agency makes an indirect loan, it normally becomes a holder in due course of the negotiable instrument.<sup>49</sup> As a result, its claims against the maker of the instrument usually cannot be defeated by defenses arising from the contract signed in conjunction with the negotiable note.<sup>50</sup> The buyer's only remedies are either

47. Legal aid lawyers interviewed stated that prior to the Act clients almost never complained within a day of the sale. Interviews with staff lawyers, New Haven Legal Assistance Association, Inc., New Haven, Conn., January 1969. For a general discussion of the length of a cooling-off period, see Sher, *supra* note 4, at 756-60.

48. UCCC § 2.502. See also ILL. ANN. STAT. ch. 121½, § 262B (Smith-Hurd Supp. 1968).

49. The requirements of a negotiable instrument are set out in UCC § 3-104(1). A financing agency becomes a "holder" by purchasing a negotiable note. UCC §§ 1-201(20), 3-102(1)(e). A holder is a "holder in due course" if he takes for value, in good faith, and without notice that the instrument is overdue, has been dishonored, or is subject to any claim or defense. UCC § 3-302. For a limited discussion of the case law interpretation of these provisions, see notes 62 & 63 *infra*.

50. Except for certain defenses enumerated in UCC § 3-305, a holder in due course takes the instrument free of all claims to it on the part of any person and all defenses of any party with whom the holder has not dealt. The exceptions seldom arise; they include infancy, duress, and "real" or "essential" fraud. The test in determining this latter category is "excusable ignorance of the contents of the writing signed." UCC § 3-305, Comment 7.

It should be noted that legal positions similar to those created by negotiability are created by certain "waiver-of-defenses" clauses. These clauses customarily provide that the

Buyer hereby acknowledges notice that the contract may be assigned and that assignees will rely upon the agreements contained in this paragraph, and agree that the liability of the Buyer to any assignee shall be immediate and absolute and not affected by any default whatsoever of the Seller signing this contract, and in order

to join the breaching seller in a suit brought by the financial institution or to bring a separate action against the seller. Both of these possibilities are unavailable if the seller is insolvent or has disappeared.

The holder in due course status has long been justified on the grounds that it is needed for the free movement of commercial paper.<sup>51</sup> Financing agencies do not want to take claims which are subject to contract defenses, and this reluctance damages the businessmen who rely upon financing agencies to purchase their customers' notes. Many businessmen need ready cash, and it is only by selling these notes to

to induce assignees to purchase this contract, the Buyer further agrees not to set up any claim against such seller as a defense, counterclaim or offset to any action by any assignee for the unpaid balance of the purchase price or for possession of the property.

*Unico v. Owen*, 50 N.J. 101, 106, 232 A.2d 405, 408 (1967). The validity of these clauses has often been judicially upheld. See *Anglo-California Trust Co. v. Hall*, 61 Utah 223, 211 P. 991 (1922). But see *American Nat'l Bank v. A.G. Somerville, Inc.*, 191 Cal. 364, 216 P. 376 (1923). For a compilation of cases on both sides of the issue, see *Gilmore, supra* note 5, at 1096-97 n.118; *Jordan & Warren, supra* note 5, at 434 nn.132 & 134.

UCC § 9-206 approves a waiver-of-defenses clause unless the enacting state has a conflicting statute or court decision for consumer goods. The Connecticut Act does not explicitly prohibit waiver-of-defenses clauses, but Section 136(a) provides that a transferee "shall be subject to all claims and defenses of the buyer . . ." (emphasis added). This provision, interpreted in the light of the legislative intent to eliminate negotiability in home solicitation sales, should invalidate waiver-of-defenses clauses or other provisions having the same effect. See generally Littlefield, *The Home Solicitation Sales Act of 1967*, 42 CONN. B.J. 436 (1968). If waiver-of-defenses clauses are given full effect by the courts, their use will become more common. Financiers would be fully protected from buyer defenses and the Act's prohibition of negotiable notes would be emasculated.

The use of completion certificates poses a related problem. Financiers will not customarily agree to purchase a consumer's note from a dealer until they receive a signed completion certificate. Note 38 *supra*. When a financier relies on a form signed by the buyer warranting that the work has been completed satisfactorily, it is possible that he takes the note free of any defenses based on lack of consideration or unsatisfactory performance. In fact, the completion certificates of major banks, which must be signed by both the dealer and the buyer, require the dealer to promise that "the makers of the Note have not asserted and will not assert any defense to the collection of the Note in accordance with its tenor."

The legal effect of such a certificate is unclear. If it is treated as a waiver of defenses, then perhaps it will be invalidated on the reasoning presented above. But a recent New York court has held that a completion certificate estops the maker from asserting defenses against financiers within 10 days of the notice of assignment even where a statute explicitly renders null a waiver-of-defenses clause within that period. *Chase Manhattan Bank v. McLeish*, 286 N.Y.S.2d 727 (Sup. Ct., App. Term, 1968). There is no rational justification for this decision. So interpreted, completion certificates, like waiver-of-defenses clauses, are inconsistent with a clear statutory policy to preserve consumer defenses. Moreover, even without considering statutory policy, a court should find for the consumer in construing a completion certificate such as the one quoted above. There, the dealer explicitly promises that the buyer will not raise any defenses against the financier; in direct juxtaposition, the consumer makes no such agreement: *expressio unius est exclusio alterius*. However, if courts are not willing to preserve consumer defenses, then the legislature should pass a law denying the validity for all purposes of a completion certificate signed before the work is satisfactorily completed. See generally MASS. ANN. LAWS ch. 255D, § 9 (1968).

51. See, e.g., J. CHITTY, A TREATISE ON THE LAW OF BILLS OF EXCHANGE 9-10 (1803).

financial institutions that they can obtain it.<sup>52</sup> While this argument is generally accepted for commercial transactions,<sup>53</sup> the use of negotiable notes in consumer sales has recently come under attack on two grounds.<sup>54</sup> First, financing agencies are better able to bear the costs of default or fraud by the seller than are individual consumers.<sup>55</sup> Second, by conditioning a financial institution's liability on the seller's adequate performance, the elimination of negotiability forces financial institutions to screen more fully dealers applying for financing and to refuse to finance the sales of fraudulent dealers.<sup>56</sup>

#### A. *Alternative Restrictions on Holder in Due Course Status*

The development of case law and the enactment of special statutes have limited both the natural effects and the misuses of negotiability.

To become a holder in due course under the UCC, the holder of a negotiable note must take in good faith and without actual knowledge of a claim or defense.<sup>57</sup> Recently courts have interpreted these requirements to furnish limited protection to the consumer.<sup>58</sup> But the argu-

52. See pp. 625-26 *supra*.

53. Gilmore, *supra* note 5, at 1101-02. But see Kripke, *supra* note 3, at 472-73. Professor Kripke seems to argue that the holder in due course status may not be needed in any context. He states that commercial parties do not need a freedom from defenses rule—indeed, in the financing of accounts receivables they do not use negotiable notes—because the commercial buyer will not tolerate the loss of defenses and financing agencies can simply include the risks in the interest charged. In consumer sales, he continues, negotiable notes are used because the contracts are adhesion contracts. These contracts should not be tolerated and financing agencies can easily incorporate the risk in the interest rate as they do in commercial situations.

54. See generally cases cited notes 59 & 63 *infra*; statutes cited note 64 *infra*; articles cited note 5 *supra*.

55. This problem can be viewed as a question of how to divide a loss between two innocent parties, the buyer or the financier, when the seller goes bankrupt or leaves the jurisdiction. For commercial transactions, the loss should arguably be put on the commercial buyer since this enhances the flow of commercial paper and both parties are economically capable of withstanding the loss. For consumer transactions, the parties are neither economically equal nor equally capable of withstanding the loss, and this factor may outweigh the policy behind negotiability. See generally Jordan & Warren, *supra* note 5, at 436; TAN 133 *infra*.

56. This policy will be referred to throughout this article as the "screening function" of the elimination of negotiability.

57. See note 49 *supra*; UCC § 3-104 (setting out the requisites of negotiability); UCC §§ 3-302 to 3-305 (defining a holder in due course). The concepts of good faith and notice overlap considerably. For instance, a holder of a note who has knowledge of an underlying contract defect can hardly be said to have met the good faith standard of honesty in fact.

58. For a somewhat dated but comprehensive state by state summary of the relevant cases, see Jones, *supra* note 5, at 197. The trend in the case law is in favor of the consumer, and most of the state appellate court decisions in recent years have preserved defenses by one means or another. See *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967), and cases cited therein. But the process is slow and many states, especially in lower courts, still hold to the traditional rules. See *Waterbury Sav. Bank v. Jaroszewski*, 4 Conn. Cir. 62, 238 A.2d 446 (1967); *Burchett v. Allied Concord Fin. Corp.*, 74 N.M. 575, 396 P.2d 186

ment that holder in due course status puts the risk on the wrong party leads, if followed, to the elimination of negotiability in the consumer context; and a court would have to ignore or overrule the Code to reach such a result.<sup>59</sup> In addition, the cases do not provide a satisfactory means of requiring financiers to screen the dealers with whom they do business. While actual knowledge of a claim or defense will deprive a financing agency of holder in due course status,<sup>60</sup> such institutions have

(1964). More importantly, the financier's threat to invoke its holder in due course status in court undoubtedly scares off many aggrieved consumers. Moreover, these cases are frequently handled in summary fashion by judges and lawyers unfamiliar with recent developments in the case law.

59. The only case which even vaguely resembles a move towards prohibiting holder in due course status altogether for holders of consumer paper is *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967). See also Comment, *Unico v. Owen: Consumer Finance Companies as Holders in Due Course under the UCC*, 54 VA. L. REV. 279 (1968). The buyer had signed both a negotiable note and a contract which contained a waiver-of-defenses clause; both were sold to Unico, a finance company. The New Jersey Supreme Court began its opinion with a policy discussion of the consumer credit industry, denied holder in due course status to Unico because of its close connection to Universal, the seller, and declared the waiver of defenses void as contrary to public policy.

The Court gave three reasons for holding invalid the waiver-of-defenses clause: (1) the clause is contrary to the policy of the Negotiable Instrument Law (*Unico* was decided prior to the enactment of the UCC in New Jersey; it is interesting to note that on the whole UCC's Article 3 is more difficult for consumers than was the NIL; see Comment, *Unico v. Owen*, *supra*, at 286), because it attempts to give the contract negotiability without the prerequisites for such status; (2) the clause is contrary to the spirit of N.J. STAT. ANN. § 2A:25-1 (1952), which states that assignees are subject to the defenses which the buyer had against the assignor at the time of notice of the assignment of the contract; and (3) the policy of the state is "to protect conditional vendees against imposition by conditional vendors and installment sellers." *Unico v. Owen*, *supra* at 124, 232 A.2d at 418. However, the first reason does not support the court's decision, and the latter two do not distinguish between a holder of a contract with a waiver-of-defenses clause from a holder in due course.

Only if the prerequisites of negotiability particularly protect the consumer—and there is no evidence that they do—does the first argument make any sense as the basis of a decision limited to consumer goods. Moreover, the very problems raised by negotiable instruments in the consumer context indicate that the form of a negotiable note is not sufficient and probably not even helpful if one's interest is in protecting consumers.

The court's second argument, that the spirit of the assignment statute is violated, collapses when these provisions are compared with UCC § 9-206, which specifically permits a waiver-of-defenses clause. It is true, as the court points out, that Section 9-206 permits a different rule for the sale of consumer goods, but it would equally support a prohibition on negotiability in the consumer context since Section 9-206(1) gives negotiability as an example of the type of agreement which can have separate consumer treatment: "A buyer who as part of one transaction signs both a negotiable instrument and a security agreement makes such an agreement." Thus, negotiability would also be subject to the use of Section 9-206 to create an exception for consumer goods.

The real basis for the court's holding seems to be the third reason—that New Jersey has a policy of protecting conditional vendees—but this reason is even more valid in attacking negotiable instruments than a simple waiver-of-defense clause. The court is concerned that the buyer—read consumer—not unwittingly lose his defenses under the contract; but this happens even more completely with a negotiable note. The waiver-of-defenses clause is at least printed on the contract for the buyer to read, whereas most consumers probably have no idea that they are effectively signing away their rights when they sign a negotiable instrument.

60. *Waterbury Sav. Bank v. Jaroszewski*, 4 Conn. Cir. 620, 623, 238 A.2d 446, 448 (1967) ("[f]ailure of plaintiff to inquire as to proper performance by [the dealer] of its underlying contract with defendants does not show a lack of good faith or alter its status under



no duty to acquire this knowledge by investigation.<sup>61</sup>

In a few cases courts have gone beyond the actual knowledge test in determining whether a financing agency holds a note in due course. Some of these cases concern the dealer's relationship with the financier—the close connection test<sup>62</sup>—while others examine the suspicious circumstances surrounding a particular transaction and apply what amounts to an objective notice test.<sup>63</sup> These situations accomplish the

[UCC § 3-302"]. See *First Nat'l Bank v. Anderson*, 7 D. & C.2d 661, 666 (Bucks Co. 1956) ("... if a holder of an instrument were required to investigate in each instance whether the contract had been completed satisfactorily before accepting it, the burden placed on the free flow of negotiable paper would be insurmountable").

61. *Goodman v. Simonds*, 61 U.S. 343 (1857); *Littlefield*, *supra* note 5, at 50-53.

62. This test has been applied both when the financier is closely involved in the individual transaction and when the financial institution has had close ties with a seller over a period of time. It may be justified on various grounds: if close connection is established the financier may be deemed to have notice of the entire transaction; the seller may be held to be the agent of the financial institution; or the financier may be considered a "party" to the transaction which has "dealt" with the buyer. But since actual notice, legal agency, or direct dealing are often not clearly shown, it is quite likely that consumer protection is the controlling factor in many of the cases. See *Jones*, *supra* note 5; *Littlefield*, *supra* note 5; and cases cited in both.

63. Despite the general rule that the financier has no duty to investigate further than the face of the note, it seems clear that at some point and with certain facts any court would require investigation before finding good faith or lack of notice of a claim or defense. See generally UCC § 1-201(25)(c): "A person has notice of a fact when . . . (c) from all the facts and circumstances known to him at the time in question he has reason to know that it exists." (Emphasis added.) The buyer-defendant must show that the financier deliberately closed his eyes to facts which he was afraid would indicate a claim or defense on the note. By refusing to investigate in such a case, the holder is said to be not in good faith. See *First Nat'l Bank v. Goldberg*, 340 Pa. 337, 340, 17 A.2d 377, 379 (1941) (failure to make inquiry must be under circumstances which "indicate a deliberate desire . . . to evade knowledge because of a belief or fear that investigation would disclose a vice in the transaction"; such circumstances not shown in this case). Or alternatively, the law "presumes that he knows whatever proper inquiry would disclose." *City of New York v. Nic Homes, Inc.*, 44 Misc. 2d 440, 443, 253 N.Y.S.2d 926, 930 (Civ. Ct. 1964).

The question, then, is to ascertain what facts must be present before a court will impose a duty to investigate on a financial institution. These facts may relate to the seller's general business, to the particular note in question, or to the underlying sales transaction, and together they constitute what might be called the "suspicious circumstances" test of a holder in due course.

In the general business category, a court might consider the financier's knowledge of the dealer's generally poor business reputation. *Financial Credit Corp. v. Williams*, 246 Md. 575, 585, 229 A.2d 712, 716-17 (1967); *Westfield Investment Co. v. Fellers*, 74 N.J. Super. 575, 590-91, 181 A.2d 809, 818 (Law Div. 1962). *Contra*, *Universal C.I.T. Credit Corp. v. Ingel*, 347 Mass. 119, 125, 196 N.E.2d 847, 852 (1964) (evidence of knowledge of bad reputation held correctly excluded by trial court). And it might consider the financier's knowledge of the seller's fraudulent methods of business. See *Lefkowitz v. ITM, Inc.*, 52 Misc. 2d 39, 51-52, 275 N.Y.S.2d 303, 319 (Sup. Ct. 1966); *Norman v. World Wide Distributors, Inc.*, 202 Pa. Super. 53, 58-59, 195 A.2d 115, 118 (1963).

With respect to the financier's knowledge of certain circumstances relating to a particular note, courts might consider the following as suspicious circumstances: the note was on a form provided by another financing agency, see *Westfield Investment Co. v. Fellers*, *supra*, at 589-90, 181 A.2d at 817 (dictum); the note was purchased "without recourse" when the seller professed difficulty selling the note, see *Stevenson v. O'Neal*, 71 Ill. 314 (1874) (dictum); Annot., 77 A.L.R. 487 (1932); or the note was purchased at a substantial discount, see *Financial Credit Co. v. Williams*, *supra*, at 584, 229 A.2d at 716, Annot., 91 A.L.R. 1139 (1934).

limited goal of shifting the burden of risk in certain cases involving fraud or insolvency and thereby imposing a slight screening requirement on financing agencies; but they fall far short of providing adequate protection to consumers.

In contrast to the case law, special statutes restricting negotiability in the consumer context can and do shift much of the risk of the seller's fraud or default from the consumer to the financing agency. At one extreme are statutes which eliminate the holder in due course status altogether for holders of consumer paper:<sup>64</sup> a holder of an otherwise negotiable note becomes an assignee, subject to the obligor-buyer's defenses against the seller-assignor.<sup>65</sup>

A less complete elimination of negotiability is presented in the Connecticut Act and proposed in Section 2.403 and Alternative A of Section 2.404 of the UCC. Section 2.403 states that in a consumer sale a seller may not take a negotiable instrument from the buyer. But the section provides further that "a holder is not in good faith if he takes a negotiable instrument with notice that it is issued in violation of this section." The necessary implication is that if a note is renegotiated under circumstances which do not give the second or subsequent financing agency notice that the original sale was to a consumer, the later holder qualifies as a holder in due course.<sup>66</sup> Except for this loop-

In the final category—the seller's knowledge of an installment contract or other security agreement purchased simultaneously and in conjunction with the note—a court might consider as suspicious the conditional liability of the buyer. See generally *International Fin. Corp. v. Rieger*, 272 Minn. 192, 137 N.W.2d 172 (1965). But see UCC § 3-304(4)-(6). And a court might consider relevant any unconscionable clauses or oppressive terms in the contract. See UCC § 3-304(1).

In addition to the above factors, this study suggests that certain business practices are sufficiently established that a court should consider any deviation from them as a suspicious circumstance. A court would not have to adopt a good faith standard of commercial reasonableness to do this, although some courts seem to have already adopted such a standard. See *Westfield Investment Co. v. Fellers*, *supra* at 584, 181 A.2d at 814; *City of New York v. Nic Homes*, 44 Misc. 2d at 443, 253 N.Y.S.2d at 930. Rather, it would simply impose a duty to investigate if the evidence of commercial deviation indicated a desire to purposefully overlook a defect. For instance, since financiers usually establish working relationships with certain dealers, pp. 627-28 *supra*, the burden of inquiry should be imposed on a financier who buys notes from a seller with whom he has not previously done business. Similarly, since the financing agencies claim that they already investigate the dealer's general business and reputation and even each individual transaction, a financing agency which did not meet this standard of investigation should be held to have had notice of any defense which might arise. See p. 638 *infra*.

64. E.g., MD. ANN. CODE art. 83, § 147 (1968); MASS. GEN. LAWS ANN. ch. 255, § 12c (1968); VT. STAT. ANN. tit. 9, § 2455 (Supp. 1968); REV. CODE WASH. ANN. tit. 63, § 14.020 (Supp. 1968).

65. See 4 A. CORBIN, CONTRACTS § 892 (1963).

66. The Connecticut Act has a similar provision and therefore comes within this second category of statutes. Section 138(d) states: "A promissory note payable to order or bearer and otherwise negotiable in form issued in violation of this section may be enforced as a negotiable instrument by a holder in due course according to its terms." Three factors reduce the significance of this provision: (1) The initial purchaser of a

hole, any third party acquiring a claim against a consumer can do so only as an assignee. Section 2.404 Alternative A embodies the traditional contract rule that assignees are subject to all defenses which the buyer has against the seller.

A third approach eliminates negotiable notes in consumer sales on the one hand, but provides for a limited loss of defenses against assignees on the other.<sup>67</sup> Two of the most important examples of this approach are Alternative B of Section 2.404 of the UCCC and, with slight variations, the New York Retail Installment Sales Act.<sup>68</sup> The UCCC provision, for example, provides that when the buyer agrees not to assert claims against assignees—a practice which presumably will become standard where waiver of defenses clauses are legal but negotiable instruments are not—the buyer's rights and defenses are cut off if the holder gives the buyer notice of the assignment and the buyer does not assert certain claims within the time period provided in the statute.<sup>69</sup>

Whether such statutes can induce adequate screening<sup>70</sup> and whether

consumer note from a dealer would almost never qualify as a holder in due course, and there is at present very little renegotiation of consumer paper. *See* Jordan & Warren, *supra* note 5, at 436. (2) Even if there were a secondary market for negotiable notes, the financiers would be on notice of the Act's limitation. As stated in the Official Comment to UCCC § 2.403: "Since the prohibition against negotiable notes in consumer financing will be well known in the financial community after enactment of this Act, professional financiers buying consumer paper will normally not qualify as holders in due course with respect to notes taken by dealers in violation of this section and negotiated to them." (3) Banks in Connecticut supply blank notes to dealers, pp. 627-28 *supra*, which are already stamped with the required statutory notice that they are not negotiable. In interviews with several dealers and bank officials, we heard of only one bank-dealer relationship in which the bank provided both negotiable and non-negotiable notes. Therefore, at least with respect to bank financing of home solicitation sales, it is almost impossible for a negotiable consumer note to fall into the hands of a financing agency.

67. *E.g.*, DEL. CODE ANN. tit. 6, § 4312 (Supp. 1966) (15 days); ILL. REV. STAT. ch. 121½, § 262D (Smith-Hurd Supp. 1968) (5 days); TEXAS SESSION LAWS ch. 274, tit. 79, art. 6.07 (Vernon 1967) (30 days).

68. N.Y. PERS. PROP. LAW § 403(3) (McKinney 1962) (all consumer goods). *See also* N.Y. PERS. PROP. LAW § 302(9) (McKinney 1962) (motor vehicles).

69. The New York statute has a 10 day cut-off period; UCCC § 2.404 Alternative B gives the consumer three months in which to raise a defense. For a discussion of the problems with this kind of statute, see Jordan & Warren, *supra* note 5, at 435.

70. The Federal Housing Administration does require some screening of dealers in loans which it insures. Before disbursing the proceeds of an indirect loan, the FHA-insured financier must perform an investigation which he considers sufficient to find the dealer "reliable, financially responsible and qualified to perform satisfactorily the work to be financed and to extend proper services to the customer." 24 C.F.R. § 201.8(a)(1) (1968). The records of the dealer's application, the supporting information, and the insured's approval must then be maintained in the financier's office. *Id.* Where the financier is unable to approve a dealer, to obtain FHA insurance he must conduct a very strict investigation including verifying the borrower's credit position, personally witnessing the signing of the completion certificate, and actually inspecting the work performed. 24 C.F.R. § 201.8(b) (1968). In addition, the FHA has a list of persons who, if known to be in any way involved in a transaction, make the supporting loan ineligible for FHA insurance. Financiers are given notice of dealers to whom they should not grant approval

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they create undesired side effects will be considered in the analysis of the effects of the Connecticut Act.

### B. *Impact of the Connecticut Act: Financial Institutions*<sup>71</sup>

By eliminating negotiability in home solicitation sales, the Connecticut Act in the first impact shifted the balance between the consumer-purchaser and the financing agency.<sup>72</sup> Stripped of holder in due course protection, financiers<sup>73</sup> were left to trigger the chain of private actions and reactions which would determine the manner in which the door-to-door business would henceforth be conducted.<sup>74</sup>

The clearest consequence of the Act has been a marked reduction in institutional financing of businesses engaged in door-to-door sales. The reduced level of financing is clearly demonstrated by reports received in the course of this study from banks and finance companies showing the number of home solicitation dealers whom they financed before and after the Act. In July 1967 nine of the responding financial institutions did recurring business with 15 or more dealers. These nine

and of ineligible persons by a booklet distributed yearly to them listing all such individuals. Telephone discussion with Connecticut Office of the FHA, March 5, 1969.

If FHA loans were highly desirable, *see* note 34 *supra*, these procedures might motivate refusals to finance fraudulent dealers both because of the screening and approval directly required by the procedures, and because there would be a presumption with uninsured loans that they had been granted to dealers who could not meet FHA standards. Courts would then be in a strong position to deny holder in due course protection in the case of uninsured loans on the ground that the financier had knowledge of the dealer's unreliability.

71. To protect the confidentiality of financiers who gave us information, we are often prevented in this section from citing to specific sources or otherwise presenting details which might disclose their identity. The findings here are based on responses from all major Connecticut banks. *See* p. 621 *supra*.

72. Connecticut law prior to the Act strictly protected third-party financiers from suit by consumers even in egregious cases. *See, e.g., Waterbury Sav. Bank v. Jaroszewski*, 4 Conn. Cir. 620, 288 A.2d 446 (1967).

73. Fourteen of 26 banks and three of 20 finance companies responding to our questionnaires indicated that they had at the time of the Act financed home solicitation dealers.

74. Financiers have been placed in an analogous position by *Connor v. Great Western Sav. & Loan Assn.*, 73 Cal. Rptr. 369, 447 P.2d 609 (1968). Single-family home owners in a tract development brought suit for negligence against Great Western, which had both financed the tract developers and extended mortgages to the particular plaintiffs. The California Supreme Court, per Chief Justice Traynor, overruled the traditional defense of non-liability for lending institutions arguing that Great Western was intimately involved in the transaction from start to finish—employing reasoning similar to that in the “close connection” cases denying holder in due course status. *See* note 62 *supra*. The lender's new liability under this rule may cause it to cease close relations with developers altogether; but this is an undesirable result if the court's intention is to protect home buyers by forcing lenders to screen developers' work quality. Increased screening and greater reluctance to finance marginal developers are in fact more likely results since the lenders will probably find close relations with a developer an unavoidable incident of securing their loans; but the screening may lead to increased costs. Great Western argued that the imposition of the duty “will increase housing costs, drive marginal dealers out of business, and decrease total housing at a time of great need.” *Id.* at 378, 447 P.2d at 618. The elimination of negotiability creates a similar process of increased liability, causing withdrawal or increased concern by financiers, which lead in turn to increased costs.

reported together a total of 800 dealer relationships.<sup>75</sup> By August 1968 that total had been reduced by over 50 per cent to a sum of 388. The extent of the decreases varied from institution to institution. Two banks—one with about 200 dealers and the other with about 50—cut off no dealers. One finance company with 18 dealers cut off only one. On the other hand, one major bank with approximately 135 dealers got out of the business altogether. No financing agency reported a net gain of dealers in this period.

This study's figures on the volume of commercial paper handled by banks and finance companies are not comprehensive, since not all institutions provided this information. Neither are they as perfect an indication of the decline in financing as is the decrease in dealer relationships, because it was difficult for the institutions to give data for comparable time periods before and after the Act. What information was received, however, points in the direction indicated by the dealer-relationship decrease. Only one of the six banks and finance companies giving this information reported a net increase in volume<sup>76</sup>—and that increase, experienced by a bank, is relatively small compared with the decreases reported.<sup>77</sup>

To understand this decrease in financing, one must examine financiers' criteria for dealer selection and the terms of the financing arrangements. All financiers reported that they had had screening procedures prior to the Act.<sup>78</sup> All kept a record of the number of consumer complaints about a dealer and the number of past defaults by a dealer's customers. All interviewed the dealer and most checked with the Better Business Bureau, Dun and Bradstreet ratings, and any other local credit bureau available. Confidential financial statements were often, though not invariably, required.

75. This figure is larger than the total number of dealers negotiating notes since many dealers had relationships with more than one bank or finance company. In our study, only three of the 24 dealers responding reported using, prior to the Act, a single financing agency. Twelve, 50 per cent of the respondents, used two or three; six used four or five, and three dealers used six or more.

76. It is possible that there are significant increases in volume which this study did not reveal since some major institutions did not provide this information, but other factors—primarily the decline in dealer-relationships—make this possibility unlikely.

77. It may be that not all of this decrease is attributable solely to the Act. During the 1960's a few institutions had had unfavorable experience with dealer financing. One major bank which had been among the first in the field and among the most heavily involved withdrew in about 1960 after serious losses. One or two other banks reported that, due to the riskiness of the business and the possibility of developing a bad public image through association with door-to-door salesmen, they were considering cutting back their involvement in the area. For these banks, the Act was only the immediately precipitating cause of restricting or discontinuing dealer financing. In July 1967, however, there were also banks trying to break into this area of the credit market, and, for most, the Act seems to have been the single motivation for restriction of dealer financing.

78. See also Note, 114 U. PA. L. REV., *supra* note 8, at 415.

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These investigations have generally been intensified since the Act went into effect. Each of the above practices has become more regular. In addition, institutions have begun to check with suppliers and other banks and businesses which might be acquainted with the dealer. Some banks and finance companies, moreover, now undertake inspection of the dealer's work—either on-site or, more frequently, through a call to the customer. At least one financier now purchases notes on sales only within its local area, where the job can be checked and information about the dealer is more readily available.

While intensified investigations afford financial institutions more information about the dealers seeking to sell consumer paper to them, the central question is what information is most important in determining whether to accept or refuse a dealer. By conditioning a financing agency's absolute right to repayment on adequate performance by the dealer in the underlying sales transaction, the Connecticut legislature hoped to induce in banks and finance companies concern for the reliability of the dealers they were financing.<sup>79</sup> Inspection of a dealer's work and consideration of the number of complaints and defaults by a dealer's customers indicate concern for the quality of his work.

Other screening procedures have less to do with work quality. Checking Dun and Bradstreet ratings and requiring financial statements—though not inconsistent with concern for quality—go more to a dealer's solvency. That the length of relations between dealer and institution is a factor may be explained partially by concern for quality but also by the existence of personal ties. A most important factor cited by all banks and finance companies is a dealer's volume of business with that institution. Financial institutions are apparently reluctant to cut the volume dealer off, not only because of the amount of credit business he brings in, but also because of his other relations with the banks: he typically has a mortgage, savings account, and checking account of substantial size there.

The general decrease in financing, however, is not fully explained by an enumeration of the factors which might lead an institution to unconditionally refuse a dealer. At least as important in the decrease are the new obligations which financing agencies now require of those whom they are willing to finance. Fewer banks and finance companies are in the business now, and those that have stayed have found that they

79. Of course financiers can duck behind the protective shield of waiver-of-defense clauses or completion certificates if either of these is construed against the consumer. See note 50 *supra*. But there is no evidence that financiers expect this result and, in fact, their new screening procedures indicate the contrary.

can impose stricter financing conditions and still remain competitive.<sup>80</sup> These new conditions have led many dealers to discontinue business with certain institutions and discouraged others from seeking outside financing altogether.

The most important new requirement imposed by banks to protect themselves appears to be the repurchase agreement. Under this agreement, the dealer promises to repurchase the customer's note from the bank at the amount of the outstanding balance should the customer for any reason refuse payment.<sup>81</sup> Of eleven banks remaining in the business after the Act, none reported having sought such agreements prior to July 1967.<sup>82</sup> Six of the eleven now require them.

The repurchase agreement restores to financing agencies much of the security they enjoyed as holders in due course. There are, however, practical limits to the worth of the agreements—they are only as strong as the dealer's credit position,<sup>83</sup> and they can be enforced only if the dealer can be found and brought into court. Thus, when a dealer's solvency is in doubt or when he has few fixed assets to restrict his movement, financiers are unlikely to purchase his notes even under their new terms.

It might be expected that another consequence of the increased riskiness of financing would be higher financing charges.<sup>84</sup> Although some dealers reported higher interest rates,<sup>85</sup> not one bank or finance company reported an increase in the rate on home improvement loans. Nor, surprisingly, did these institutions report any increase in the frequency or amount of discounting below the cash price of the product

80. The UCCC proposes to relax and simplify licensing requirements for lenders in order to facilitate entry and thus foster competition in financing. See UCCC §§ 3.502-3.503.

81. The repurchase agreement form of one Connecticut bank, for example, specifies that dealers are contractually obligated on demand to buy back notes "if for any reason whatsoever the maker sets up any claims, defenses, set-off, or counterclaim to any note or the collection thereof."

82. Repurchase agreements joined with non-negotiable notes secure for the financier most of the advantages of fully indorsed notes. See UCC § 3-414(1). Thus financiers seeking this protection prior to the Act did not need repurchase agreements.

In fact, before the Act, dealers generally did not fully indorse their notes but transferred them to financing agencies "without recourse." This qualified indorsement placed the risk of non-payment on the holder of the note—except in the case of buyer defenses known to the seller at the time of the transfer. UCC § 3-417(3). Under the repurchase agreement, however, the dealer is explicitly put on notice that he should expect the financier to turn to him whenever it is unable to collect from the customer.

83. Thus, one bank that experimented prior to the Act with the functional equivalent of the repurchase agreement—requiring the dealer to be co-maker of the customer's note—discontinued the practice because it soon found that its dealers had spread their security so thinly that little real protection was afforded.

84. See note 134 *infra*.

85. Fifteen of 30 dealers responding so indicated. The reported increases may simply reflect rising market interest rates for all loans.

sold (the face amount of the paper).<sup>86</sup> No bank, in fact, reported that either before or after the Act it discounted below the face amount at all,<sup>87</sup> and although one finance company indicated that it presently engages in this practice, it had done so before as well.<sup>88</sup>

There are less direct ways in which financing agencies can make credit more expensive. One practice widely used by financial institutions is the reserve account.<sup>89</sup> Rather than pay a dealer outright the total face amount of the note transferred to it, the institutions typically retain a small percentage of the total—generally from 1½ to 2½ per cent—in an account under the dealer's name. The dealer may at no time draw from this account an amount which will reduce it below the established base percentage of the aggregate unpaid balances on notes purchased from the dealer. If the banks were to increase the percentage required to be maintained in the reserve account, the financing would become more expensive since the dealer would have fewer liquid resources. This study, however, found that reserve account requirements have not generally increased since the Act went into effect.<sup>90</sup> Of those reporting, only one institution—a relatively small-volume finance company—reported a change in reserve account policy.

The study revealed one method by which financial institutions now regularly take a greater return from home improvement transactions than they did prior to the Act. A majority of banks and finance companies previously gave dealers "incentive payments"—a percentage of the interest rate or other payment supplementing the amount of the

86. The term "discounting" is employed narrowly in this article to designate only the situation in which the lender takes as payment for financing an amount greater than the interest rate stated on the face of the note purchased. Elsewhere "discounting" is sometimes used to refer to financier purchase of consumer paper generally.

87. It should be noted that banks set the minimum interest rate charged the consumer by stating the fixed rates on the notes dealers use in sales. If the dealers themselves set the rate, banks would of course have to discount to secure the desired return. See note 91 *infra*.

88. It is possible that financial institutions are reluctant to disclose that they engaged in this practice and that our findings on this point are not strictly accurate. Reports from dealers suggest that discounting is sometimes employed, see p. 643 *infra*, but it does seem to be involved in only a small number of home solicitation sales.

89. Of seven institutions both responding to the question and remaining in the business after the Act, three banks and two finance companies reported having reserve accounts.

90. To the extent that financiers used dealer reserve accounts before the Act, they did not rely solely on their holder in due course protection. In cases where they took notes with recourse, rather than bringing suit against a defaulting borrower, financiers might simply recover from the dealer's reserve account. In the usual case in which notes were purchased without recourse, reserves were available for recovery in the few situations in which qualified indorsement allows financing agencies rights against dealers. See note 82 *supra*.



sale price.<sup>91</sup> Some institutions seem to have given this payment to all dealers; others only to certain favored dealers. Although the responses do not indicate the exact degree of change in this practice, it is a fair conclusion that the incentive payments have been considerably restricted—some institutions have discontinued the practice altogether and others have reduced the percentage or the number of dealers participating.

Finally, many institutions since the Act have come to prefer direct to indirect loans.<sup>92</sup> One bank has found that by shifting its resources to advertising to consumers rather than soliciting dealers it has increased its direct loan business and had fewer defaults on home improvement loans. The reasons for preferring direct loans are clear: the bank can personally interview and directly evaluate a credit applicant—it need not worry about error caused by the dealer's eagerness to make a sale—and the bank has an opportunity to attract the customer's whole range of banking business. Most important, since the elimination of negotiability does not change the bank's legal position on direct loans, the borrower's obligation to repay on a direct loan is not conditioned on adequate performance by the dealer.

### C. *Impact of the Connecticut Act: Dealers*

Home solicitation dealers recognize that fraud and sharp selling practices have given them a public image which hurts their business and makes them likely subjects for regulation. Every dealer responding to this study reported that fraudulent salesmen had operated in Connecticut prior to the Act.<sup>93</sup> A majority were also of the opinion that anyone, reputable or not, could secure financing under the old procedures.<sup>94</sup> The dealers varied greatly, however, in their reactions to the effects of the Act. The responding dealers split on the proposition that banks should be forced to take greater responsibility for home solicitation sales,<sup>95</sup> and there was a similar disagreement on whether the

91. Normally a financier puts the market rate of interest on his notes. He may pay dealers part of the interest in addition to the cash price to maintain and attract business.

92. Direct loans are normally made without the dealer's involvement, but the practice of institutions making such loans on dealer recommendations is not unknown. One of seven financing agencies—four banks and three sales finance companies—reported making direct loans on the seller's recommendation. See p. 645 *infra*.

93. The responses to the question: "Do you think that dealers before July 1967 used practices which were unfair to customers?" were as follows: most dealers, 3; many dealers, 7; some dealers, 27; very few dealers, 12; no dealers at all, 0 (total responses, 49).

94. Thirty-three of 48 respondents so indicated.

95. Thirty-two of 48 respondents so indicated. Those who favored the increased responsibility of financial institutions indicated that the Act would "weed out the crooks," "help honest businessmen," and provide "more protection for the consumer." Those opposed

fraudulent practices which existed before July 1967 have been changed since then.<sup>96</sup>

Behind these differing opinions about the worth of the Act lie the practical effects of the financing agencies' new practices. It appears that while several dealers have been considerably damaged, others have been unaffected. Almost half of the dealers reported that it had become more difficult to obtain financing since the passage of the Act.<sup>97</sup> Twenty dealers<sup>98</sup> indicated that financial institutions with whom they dealt had adopted new financing procedures since July 1967, and ten of these dealers found the procedures so exacting and arduous that they either could not or would not comply. More than one-third of the thirty-two dealers<sup>99</sup> who had received "incentive payments" prior to the Act no longer receive them. Over half of the dealers who have found it necessary to accept repurchase agreements have done so only since the Act.<sup>100</sup> Nine dealers must now discount their notes<sup>101</sup>—only five did so before the Act. The number of dealers who reported that over 50 per cent of their credit sales were financed by indirect loans fell from 28 to 19.<sup>102</sup> Finally, a number of dealers were not even offered new procedures as the price of continued credit: 15 of 46 responding dealers reported

to the Act's emphasis on the involvement of financial institutions stated their belief that "banks are lending institutions, not policemen," "banks sell money, not roofing and siding," "it has made financing for legitimate businessmen harder to obtain," and "let the buyer beware." A middle position was presented by one dealer who said he favored increased bank responsibility if well done, but not as required by the Act: "There must be a better way, as this can manifest itself to a greater control over all industry. Eventually to telling the individual how, what, when, and wherefor bringing about the total loss of decision making. We will grant that something should be done but discriminatory legislation is not the answer."

96. Twenty-three of 45 felt that there has been a change since July 1967. Several reasons for the change were reported: the Act "has put dishonest dealers out of business," since "the fly-by-nighters cannot get financing"; dealers "are afraid to conduct anything but an honest business"; and "more interest is shown by home owners in financial matters caused by publicity of Act." Other dealers reported, however, that "the few unfair dealers will still operate," some financial institutions will still "handle anyone," and the fraudulent dealers "have new methods developed by now. You cannot beat them."

97. Twenty-two of 50 reported that it is more difficult for them to obtain financing now than it had been prior to the Act. Most of the difficulty is undoubtedly related to the substantive changes in financing practices. But many dealers also complained of the heavy burden of increased paperwork imposed by the financiers' new screening practices and financing requirements.

98. Thirty-seven dealers responded to this question.

99. Thirteen dealers reported losing "incentive payments."

100. Seventeen of 44 responding dealers reported agreeing to repurchase agreements—ten of these had not done this prior to the Act. No financial institutions reported employing repurchase agreements prior to the Act. See p. 640 *supra*.

101. Forty-eight dealers responded to this question. Note that no banks reported discounting. See pp. 640-41 *supra*.

102. It is impossible to separate those dealers who did not answer the question from those who finance none of their sales by indirect loans, so a total number of respondents cannot be given.

that at least one financial institution which had previously purchased their consumer paper refused to do so after the Act went into effect.

Several dealers seem to have found it virtually impossible since the Act to obtain any financing at all and have been forced out of business. Estimates of the number of such persons range as high as 50 or 60.<sup>103</sup> Eleven dealers stated that they personally knew of men who had had to give up their businesses since October 1967.<sup>104</sup> Most of these persons could not be located; those who were reached were still operating, but their businesses had been severely damaged by the inability to sell consumer paper.

Faced with this difficulty in obtaining financing for credit sales, dealers had three options. First, they could stop operating door-to-door and work instead out of a business office. This decision would place them outside the scope of the Act and allow financing with negotiable notes just as before. There is almost no indication, however, that the dealers changed their business methods in this way—only four dealers reported any shift of sales away from the home.<sup>105</sup> Thus, if the Act was designed to discourage home solicitation sales, it did so only by driving sellers out of business altogether.

Second, dealers could continue to sell on credit, but rather than selling the consumer's note to a financier they could carry it themselves. To secure liquid resources dealers would then normally have to take out their own loans. To minimize the amount they would have to borrow, dealers could shorten the five-year payment terms normally offered consumers; where possible, dealers might even limit consumers to 30-60-90-day credit arrangements.<sup>106</sup> It is clear from the interviews conducted during this study that some dealers who are unable to find financiers to purchase their paper or who are unwilling to accept the new conditions imposed by financiers have preferred the alternative of financing consumer sales themselves.

Third, dealers could simply try to decrease their percentage of credit sales. This has been the predominant form of accommodation to the Act. Of 48 dealers reporting on the change in credit use, 23 had de-

103. Interviews with Connecticut dealers, spring 1968.

104. Thirty-five respondents knew of no such persons. On the questionnaires we were told of over 30 dealers who had gone out of business and we were given the names of 15 of these.

105. In contrast, 43 reported that they had not "shifted sales away from the home in any way." Dealers may have felt that financiers knew them as door-to-door sellers, and since they could not easily determine how any particular sale was made, financiers would conservatively continue to regard these dealers as within the scope of the Act.

106. With such short-term financing, dealers might offer "open" credit terms whereby the customer does not pay interest on the outstanding debt.

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creased their percentage of sales on credit, and only one had increased the percentage of such sales.<sup>107</sup> Dealers could satisfy the consumer's need for credit and still increase cash sales by encouraging buyers to obtain direct loans from financial institutions. This approach, however, requires consumer initiative and satisfactory credit standing,<sup>108</sup> and few dealers reported an increase in the number of sales financed by direct loans.

A dealer can expedite the direct financing process by establishing relations with particular lenders to whom he can refer his customers. This financing method would preserve most of the convenience of indirect loans and might not be covered by the Act.<sup>109</sup> Several major financial institutions have accepted the practice of making direct loans on dealers' recommendations and it seems likely to become a widespread method of financing home improvement sales.

Since the decrease in credit sales seems not to have been fully offset by an increase in direct loan financing, one would expect to find that dealers have suffered a decrease in sales volume. Such a decrease, however, does not seem to have occurred.<sup>110</sup> Twenty-two dealers reported an increase in

107. Of the 23 decreases, 9 were of a magnitude of 25 per cent of total sales or more. The following table displays the incidence of the decreases. The totals in the right-hand column indicate the number of dealers in each credit category prior to the Act. The numbers in the diagonal line marked with asterisks stayed within the same category subsequent to the Act; the numbers to the left of the diagonal show the decreases. Thus, of 14 dealers employing indirect loans in from 50 to 100 per cent of their total sales prior to the Act, eight remained in that group after the Act, five dropped to the 25-50 per cent class and one discontinued indirect loan financing altogether. Note that small changes, such as the one reported increase which was from 35 to 40 per cent, are not reflected as a shift from one general category in the table to another.

COMPARISON OF PERCENTAGES OF DEALERS' SALES FINANCED BY INDIRECT LOANS BEFORE AND AFTER THE ACT (BY NUMBERS OF DEALERS)

Loan Percentages Prior to the Act	Loan Percentages Subsequent to the Act					Total
	0%	1-5%	6-25%	26-50%	51-100%	
1-5%	1	3*	0	0	0	4
6-25%	2	3	8*	0	0	13
26-50%	0	3	6	8*	0	17
51-100%	1	0	0	5	8*	14
Total	4	9	14	13	8	48

108. See pp. 654-55 *infra*.

109. It is unclear whether the Act covers direct loans on dealer recommendations. See note 35 *supra*. If it is resolved that it does not, then such financing could easily be used to impair the consumer benefits of the Act.

110. Our figures on dollar volume are less complete and less exact than those on credit decrease. Sixteen dealers did not respond at all to any of the questions on dollar volume and sales volume. See Appendix, Dealer Questionnaire, questions 28 & 29. From the answers which were completed it was difficult to find appropriate blocs of time before and after the Act to compare since most dealers' accounting is done on the calendar-year basis.

business volume since July 1967. Only four dealers reported a decrease, and the volumes of nine others remained about the same.

These figures on sales volume, imprecise and uncertain as they are, need to be squared with the very clear findings of a squeeze in indirect financing and consequent decrease in credit extension by a significant number of dealers. There may be several explanations for the surprising business volume figures. Business pride may have led some of those suffering losses not to answer this question and others to respond only with their best figures.<sup>111</sup> Furthermore, dealers forced out of business by the Act did not respond to the questionnaire at all. Then, too, 1968 seems to have been a generally good year for home improvement sales.<sup>112</sup> Most of the explanation, however, probably lies in the dealers' reactions to the Act. By requiring their customers to pay cash, whether from savings or with the proceeds of a direct loan, the dealers could avoid the new bank procedures. Thus, some dealers indicated that they had shifted their sales to higher-income customers who would not be as likely to require credit.<sup>113</sup> Moreover, the dealers may have worked harder soliciting sales in order to find cash buyers. Finally, the dealers may have charged higher prices on fewer contracts, thereby avoiding a loss in gross profits.<sup>114</sup>

These considerations suggest that the reports of constant or slight increases in sales volume<sup>115</sup> may belie lost net income for the responding dealers. While the dealers may have been able partially to raise prices or increase their work effort—resulting in a constant or increased total volume of sales—they probably have not been fully able to recoup their costs. These dealers are also damaged competitively to the extent that they have failed to expand their sales level to keep pace with an expanding and inflationary market.

111. There was great discretion in selection of figures since questions of number of sales and dollar volume on sales were divided into a total of thirteen different time periods and the interpretative judgment of increase was based on whatever the dealer reported in any of these time periods.

112. The total amount of all repair and modernization loans increased in 1968 by about \$200 million dollars. No other year in the 1960's experienced so large an increase, and in 1967 there was a decrease. 55 FED. RES. BULL. A-52 (1969).

113. Twenty-one of 46 dealers reported that since October 1967, they "sell to different types of customers (for example, persons who are smaller credit risks)." Unfortunately, these figures are unreliable as many dealers, judging by their comments, seem to have misunderstood the question. See Appendix, Dealer Questionnaire, question 6(e).

114. Thirty-one of 46 dealers reported that they had increased the prices charged customers since October 1967. There are, however, so many factors such as increased cost of materials, workmen, and living as well as larger consumer demand or disposable income involved in a decision to increase prices that it is impossible to separate out the number and portion of these increases directly attributable to the Act.

115. Thirteen dealers reported either no change in volume or only a slight increase, and another four suffered decreases.

On the basis of interviews and responses to financing agency questionnaires, a tentative description of the class of dealers which has been damaged by the effects of the Act was developed. The damaged dealers are small, do "general repair" work,<sup>116</sup> sell largely by the straight door-to-door method or perhaps the "phone-home" method,<sup>117</sup> make a high percentage of credit sales, and sell a high percentage of their paper to financing agencies. Several considerations support the accuracy of this description. Small dealers operate largely door-to-door. This method involves very little capital investment—it does not require the resources that are necessary to open and staff an office or to advertise one's business. Only slightly more capital is required to secure lists and solicit from them by phone. Likewise, smaller businesses engage largely in "general repair" work; larger contracts such as swimming pools and air conditioning require greater resources and more workmen than they can invest in a single job. Furthermore, such dealers work largely in lower-income areas where the customers are thought to be less likely to take the initiative and find a dealer on their own, more vulnerable to the sales pitch,<sup>118</sup> and more in need of modest repair services. Such customers generally can make purchases only on credit, and to extend credit smaller dealers need to convert the consumer paper into present cash in order to purchase the supplies necessary to do the job.<sup>119</sup>

Dealers sharing these characteristics are likely to be hardest hit by the practices adopted by the financial institutions in response to the Act. Straight door-to-door sellers are clearly within the scope of the Act's restrictions.<sup>120</sup> As smaller firms, they do not bring in a significant amount of credit business for financing agencies, nor do they offer much other profit-making business to financiers.<sup>121</sup> The low-income customers of these dealers offer the highest credit risk. Finally, small businesses are least likely to have sufficient resources to cover a repurchase obligation in the case of a high number of customer defaults.<sup>122</sup>

The questionnaire responses from dealers provide support for the above description, which was suggested by interviews and the financing agency questionnaires. In the first place, the results clearly support the conclusion that small firms tend to do straight door-to-door solicitation

116. See p. 623 *supra*.

117. See note 29 *supra*.

118. See D. CAPLOVITZ, *THE POOR PAY MORE* xxi, 63-80 (1963).

119. See p. 625 *supra*.

120. Financing agency officials report that because they are uncertain of the scope of the Act, they refuse to take negotiable paper on any contracts in any way solicited or signed in the home. See note 30 *supra*.

121. See pp. 639-40 *supra*.

122. See p. 640 *supra*.

and general repair work, while large firms are more likely to operate out of an office and perform major additions and alterations.<sup>123</sup>

123. The following table comparing size of business with type of work shows that (1) four-fifths of the one-man firms do general repair work, while only about half of the large firms do such work, and (2) large firms are more likely than small firms to engage in the more substantial work of major alterations or additions.

COMPARISON OF BUSINESS SIZE WITH TYPE OF WORK  
(BY NUMBER OF DEALERS)

Type of Work	Size of Business		Total
	One or Two-Man Firms	Larger Firms	
General Repairs	12	13	25
Major Alterations or Additions	3	12	15
Total	15	25	40

With respect to sales techniques, there is a contrast between the groups that engage in the two methods which might be regarded as being at opposite ends of the spectrum of dealer sophistication: those, on the one hand, who operate at least partially by the straight door-to-door method and those, on the other, who do part of their work entirely out of an office. Thus, 71 per cent of the large firms do no straight door-to-door solicitation while only 45 per cent of the small firms fall into this category.

COMPARISON OF BUSINESS SIZE WITH STRAIGHT DOOR-TO-DOOR SALES METHOD  
(BY NUMBER OF DEALERS)

Size of Business	0	Percentage of Sales Done by Straight Door-to-Door Method			100%	Total
		25%	50%	75%		
One or Two-man Firms	9	4	1	3	3	20
Larger Firms	22	4	1	2	2	31
Total	31	8	2	5	5	51

Furthermore, almost 88 per cent of the dealers who do some of their contracting entirely in an office are large firms while less than 50 per cent of the firms who do no such work are large.

COMPARISON OF BUSINESS SIZE WITH "BUSINESS-CONTRACT" SALES METHOD  
(BY NUMBER OF DEALERS)

Size of Business	0	Percentage of Sales Done by "Business-Contract" Method			100%	Total
		25%	50%	75%		
One or Two-man Firms	18	2	0	0	0	20
Larger Firms	17	8	4	1	1	31
Total	35	10	4	1	1	51

In addition, none of the firms which do all of their work on a straight door-to-door basis are engaged in major alterations or repairs.

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Second, the results indicate that, in institutional financing and credit sales, small dealers who concentrate on door-to-door selling have been competitively disadvantaged relative to large firms by the effects of the Act. Before the Act was passed, credit sales and bank financing were not concentrated in any portion of the home improvement business.<sup>124</sup> There was no correlation between size of firm and percentage of credit sales a dealer made, between method of doing business and percentage of credit sales, between size and degree of reliance on indirect loans, or between method of doing business and reliance on indirect loans. By the time of this study, however, significant correlations could be found. Prior to the Act, seven of 15 one-man firms

COMPARISON OF TYPE OF WORK WITH STRAIGHT DOOR-TO-DOOR SALES METHOD  
(BY NUMBER OF DEALERS)

Type of Work	Percentage of Sales Done by Straight Door-to-Door Method					Total
	0	25%	50%	75%	100%	
General Repairs	14	4	1	3	3	25
Major Alterations or Additions	10	2	1	2	0	15
Total	24	6	2	5	3	40

It is interesting to note that the newer firms, contrary to what one might expect, are not among the smaller repair businesses. All five firms in our study which have been in business less than five years are in the big firm category—three of these are also engaged in "major home improvements." It is the oldest firms which tend to be small and engaged in general repair work.

COMPARISON OF NUMBER OF YEARS IN BUSINESS WITH TYPE OF WORK  
(BY NUMBER OF DEALERS)

Type of Work	Years in Business			Total
	1-5	6-15	Over 15	
General Repairs	1	8	15	24
Major Alterations or Additions	3	6	6	15
Total	4	14	21	39

COMPARISON OF NUMBER OF YEARS IN BUSINESS WITH BUSINESS SIZE  
(BY NUMBER OF DEALERS)

Size of Business	Years in Business			Total
	1-5	6-15	Over 15	
One or Two- man Firms	0	8	11	19
Larger Firms	5	11	15	31
Total	5	19	26	50

Thus, it seems that in recent years a number of large businesses have entered the market to challenge older one- or two-man firms.

124. See note 32 *supra*.



used indirect financing in at least three-quarters of their credit sales; only three did so after the Act, a 57 per cent decrease. By contrast, 15 of 31 large dealers used indirect financing for three-quarters or more of their sales, and this figure dropped by only 20 per cent (to 12). Similarly, 60 per cent of the one-man firms, as opposed to fewer than 40 per cent of the large firms, were forced to restrict the number of their credit sales.<sup>125</sup>

The same pattern of discrimination is found in the relationship between methods of doing business and number of credit sales. Among the 20 dealers engaged in some straight door-to-door sales, 11 (55 per cent) suffered a decrease in credit sales, while only 12 of 31 (39 per cent) of those not engaged in such sales suffered a decrease. Seen from the other extreme, three (19 per cent) of 16 firms which complete some of their sales in a business office suffered a decrease in credit sales while 20 (57 per cent) of the 35 others were forced to restrict credit sales.

#### *D. Impact of the Connecticut Act: Consumers*

The Connecticut Act must finally be evaluated against the standard it sets as its ultimate purpose: protection and advancement of consumer interests. The critical question in this evaluation is to determine the working balance between the benefits of increased concern for work quality and availability of defenses on the one hand and the increased cost to the consumer on the other.<sup>126</sup>

##### *1. Availability of Defenses*

The elimination of negotiability extends directly to consumers one clear legal benefit which does not depend in any way on private business

125. Nine of 15 responding one- or two-man firms extended credit in fewer sales subsequent to the Act; 12 of 31 larger firms did so.

126. The previous sections have described the adjustments we found to have occurred in the Connecticut business community since the Act. Financiers and dealers are discrete, identifiable groups affected directly in their day-to-day work by the Act; as such, it was practicable to conduct an empirical investigation of the Act's impact on them. Our resources, however, did not permit us to survey empirically the group of consumers affected by the Act, since this group, which includes everyone receiving door-to-door solicitations, is too large and ill-defined. Moreover, the Act's effects on the individual consumer in this group is usually so slight and the consumer so unaware that the accuracy of the results of such a survey would be open to serious challenge. Our findings then go only to the forms that the business community has devised to pursue its self-interest in the new legal context. Yet, these findings are relevant to the question of effects on the consumer in two significant respects. First, much of the Act's interest for consumers lies in its impact on fraudulent dealers and these can be most directly determined by an examination of financing agencies and dealers. Second, information about financing and selling practices cuts down the number of unknowns in the consumer protection formula, thus providing an underpinning of real-world knowledge on which to base more theoretical conclusions about the Act's ultimate effects on consumers.

ordering: the consumer may now defend in a suit brought by a financing agency for non-payment of his note by introducing proof of the dealer's unsatisfactory performance under the contract. This procedural enlargement of the buyer's remedies decreases the costs to individual consumers in two ways. First, when the dealer is solvent and subject to suit, the buyer can now avoid the expense of either joining the dealer in defense of a suit brought by the financier or bringing a separate action against the dealer. Second, where the dealer is insolvent or unavailable, the buyer can shift onto the financier the loss which he previously bore alone.

This change in the financiers' liability creates in turn an increased concern for adequate performance by the dealers whose paper they purchase, and, at the same time, it makes indirect loans riskier and thus more costly.

### 2. *Screening of Dealers*

While the Act's elimination of negotiability does not directly obligate financial institutions to screen out fraudulent dealers, the theory underlying the consumer protection model is that such screening will be induced and benefit consumers. This theory, however, is based on certain assumptions which may not be valid. In the first place, the screening may not touch dealers who use "sharp" but not illegal practices—those dealers, for example, who employ high-pressure sales tactics and who sell at higher prices than are merited by their cheap products and hasty work. The elimination of negotiability does not induce the financing agency to cut off these dealers, because their work, while grossly inferior, does not provide the consumer with any valid grounds for non-payment.<sup>127</sup>

Secondly, the consumer protection model assumes that the financial institutions will profit only if there are few defaults. But financing those dealers who occasionally engage in illegal practices can be profitable if the dealers are willing to pay a charge appropriate to the risk they represent to the financier.<sup>128</sup> In home solicitation sales, at least, there is reason to believe that the fraudulent dealer will be able and willing to pay the higher financing charges. Since the door-to-door buyer nor-

127. If, moreover, financiers charge the same rates for financing to all, dealers would find "sharp" tactics to be the most profitable mode of operation if these tactics provide the largest net return on each sale.

128. This economic model is limited to the extent that financial institutions will refuse to finance a profitable but fraudulent dealer out of fear of acquiring a bad name and thereby losing other business.

mally does not go into the market place to compare different sellers, products, and prices, such a dealer might expect to profit by making more sales, charging higher prices, and providing lower quality goods than do honest dealers.<sup>129</sup> Moreover, the rate which the financial institution needs to charge the dealer to cover its costs might not fully reflect the extent of the dealer's fraudulent activities. The typically passive consumer will often pay without complaint even though he has an actionable claim. Or, if the consumer initially resists payment, he will often cave in when the financial agency applies informal or legal pressure.

Since there was no way to determine definitely which dealers were fraudulent, the findings of this study do not directly indicate whether such dealers have been injured or put out of business by the elimination of negotiability.<sup>130</sup> But the general business practices that have developed under the Act suggest the probable impact upon fraudulent dealers.

Most financial institutions do seem to have instituted new screening methods.<sup>131</sup> Some of these procedures—such as checking individual jobs and consulting the Better Business Bureau—are related to the quality of the dealer's work and to this extent it appears that financiers share the consumer's concern with the dealer's standard of performance.

The pressure the Act imposes on financiers to screen out inferior dealers is, however, partially undermined by the use of repurchase agreements.<sup>132</sup> The repurchase agreement restores much of the insulation from buyers' defenses that financing agencies enjoyed as holders in due course. Though there are practical limitations which prevent the reliable use of agreements with dealers who might easily leave the jurisdiction or with very questionable operators, in ordinary cases the agreements enable the bank or finance company to be nearly as unconcerned about the quality of the work financed as it was before the Act.

Moreover, when financial institutions do not employ repurchase agreements or to the extent that they must look for assurances beyond the agreements, it appears that they are not concerned with the dealer's performance alone; the amount of work a dealer does with the financier and the size of the dealer's business appear to be very important con-

129. See Sher, *supra* note 4, at 726.

130. For a description of dealers injured by the Act, see p. 648 *supra*.

131. See p. 638 *supra*.

132. Of course repurchase agreements in no way negate the effects of the Act in providing for the availability of defenses. See generally p. 640 *supra*.

siderations in deciding whether to finance him. Decisions based on these overlapping factors do assist the consumer to the extent that they cut out the fly-by-night operator, but at the same time they damage the much larger group of legitimate small businessmen. Screening done in this manner—on grounds largely irrelevant to buyers—will reduce the number of dealers in the home improvement business. This decrease will deprive some consumers of services altogether and injure others to the slight extent that competition imposes price and quality constraints on door-to-door sellers.

### 3. *Increased Costs to Consumers*

With negotiable notes, certain consumers who receive inadequate performance are forced to bear the costs of insuring the free movement of consumer paper; their interests are, in effect, sacrificed to the economy's alleged need for negotiability. The elimination of negotiability lifts this burden from these individual buyers, but the costs of unsatisfactory performance by the sellers, plus the additional costs created by the change in the law,<sup>133</sup> must be borne by someone.

Exposing financiers to consumer defenses makes business riskier and thus costlier for them. Previous sections of this study described how financial institutions—through the use of repurchase agreements, discounting, and the elimination of incentive payments, for example—have largely shifted these new costs to dealers.<sup>134</sup> It seems likely that dealers have in turn passed most of these increased costs back to consumers.

Dealers can shift costs to consumers by raising their prices, lowering the quality of their products and services, and employing pressure sales tactics.<sup>135</sup> The consumer, in theory, would react to these devices by

133. The possibility that financial institutions have overreacted to the Act and have thereby created additional costs is discussed at p. 655 *infra*.

134. By raising interest rates, financial institutions can shift some of the costs directly to consumers. This is an expected result of the Act, but our data on this practice is incomplete. See pp. 640-41 *supra*.

135. Such changes would be the expected reaction to each of the dealer's new burdens. Repurchase agreements might arguably increase the seller's sense of responsibility to the buyer. However, this seems true only to the extent that the financier is a more effective complainant than the consumer who has always had the right to sue for inadequate performance. The new element introduced by the repurchase agreement is that the dealer will effectively lose his financing in any case in which a consumer for any reason, valid or not, refuses payment. This represents a significant rise in costs for the dealer which he would have to pass on if he were to maintain his profit level. The elimination of incentive payments might be said to benefit the consumer in that he is thus given a more accurate picture of the costs of credit, but this seems an academic advantage for the uncritical door-to-door buyer, and once again it represents an increased cost to the dealer which is likely to be passed on to consumers. Discounting is the clearest case of increased charges to the buyer. If the interest rate represents the market cost of credit,

buying fewer goods or by purchasing instead from retailers not forced to make such changes. It seems, however, that in practice the passivity of the door-to-door buyer does allow many dealers to shift most of the costs onto the consumer:<sup>136</sup> the discipline of competition is ineffective where customers do not go into the market to compare prices and quality.

Even though many of the costs of inadequate dealer performance and the change in the status quo may be shifted back onto consumers, the Act causes a more even-handed distribution of these costs. Rather than falling totally on the chance victim of poor performance, the costs are spread among all home improvement consumers.<sup>137</sup>

#### 4. *Direct Loans*

A consequence of the increased financing costs for indirect loans and the financier's refusal to handle some of these loans at all has been a general switch to direct loans. Although consumers are obligated to repay direct loans regardless of the quality of the dealer's performance, the trend to direct loans appears to work against sharp dealing and fraud.<sup>138</sup> Unlike a sale with attached financing papers, the buyer's inertia with a direct loan is on the side of not making the purchase. The buyer is not likely to sign a cash contract until he has gone to a financial institution and secured a loan. This gives the buyer an automatic "cooling-off" period after the sales pitch, and it may induce him to consider alternative purchases. Securing a direct loan may also force him to consider the credit terms more carefully than in the case of an indirect loan, where the interest rate is difficult to distinguish from the product price. Finally, direct loans cut out the middleman and such unseen costs as discounting and incentive payments.

The shift to direct loans, however, may have an adverse effect on low-income consumers. Such persons are frequently hesitant to enter into dealings with bankers. Also, before the Act, as part of a larger on-going business arrangement with dealers, financiers were willing to pur-

it may be assumed that the amount of the discount is the margin of extra cost which must be paid for financing through door-to-door dealers rather than through ordinary retailers.

136. This shifting is limited, however, since at some point even the passive consumer will become sensitive to higher charges and lower quality.

137. For a partial application of loss distribution theories to negotiable instruments, see Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, 549 (1961).

138. To the extent that direct loans are made on dealer recommendations, they more closely resemble indirect loans and take away some inconvenience which might cause the consumer to evaluate a purchase critically. See p. 645 *supra*.

chase the notes of customers to whom individually they would either charge very high rates or refuse credit altogether.<sup>139</sup> Since low-income buyers are dependent on credit merchandising to secure their small share of consumer goods, such buyers might be seriously hurt by the general switch to direct loans.

### E. Conclusion

The debate over proposals to eliminate or restrict negotiable notes in consumer transactions has revolved primarily around alleged consumer benefits on the one hand and corresponding detriment to financial institutions on the other.<sup>140</sup> This study shows that this characterization of the issues is misleading. First, while the elimination of negotiability per se places major additional costs on financiers, these institutions are able to pass most of them on. Second, dealers, rarely considered in previous discussions, bear many of the additional costs, and some are seriously injured by difficulty in obtaining financing. Third, although consumers directly benefit from the Act, they must ultimately bear much of the cost of the change.<sup>141</sup>

An evaluation of the elimination of negotiability in consumer sales must take into account its effect on overall economic costs to society. The primary costs of operating with negotiable notes stem from dealer fraud.<sup>142</sup> Eliminating negotiability makes fraudulent dealers bad credit risks, and thus induces financial institutions to be reluctant to take their notes. The findings of this study suggest that financiers impose important new restrictions on dealers which should reduce the extent of fraud in sales. On the other hand, the conservative reaction by most banks and finance companies to the elimination of negotiability in Connecticut has created another cost—widespread difficulty in marketing consumer paper. This apparent overreaction has resulted in higher charges to consumers and damage to legitimate businessmen. Whether these costs more than offset the benefits from restrictions designed to penalize fraudulent dealers is impossible to calculate exactly.

It may be predicted, however, that as experience with the use of

139. See C. PHELPS, FINANCING THE INSTALLMENT PURCHASES OF THE AMERICAN FAMILY 60-69 (1954).

140. Compare Gilmore, *supra* note 5, at 1101, with Kripke, *supra* note 3, at 470.

141. This issue of increased costs to consumers is mentioned but not discussed in Kripke, *Chattel Paper as a Negotiable Specialty under the Uniform Commercial Code*, 59 YALE L.J. 1209, 1222 (1950).

142. Fraud creates three types of costs. An injured party suffers an absolute loss when he is unable to recover from the fraudulent party; even when he is able to recover he incurs legal or other incidental costs in doing so; and any person attempting to avoid being defrauded incurs the costs of taking protective measures.

nonnegotiable notes accumulates, there will be a trend in financing practices toward a more rational calculation of risks. This trend can be encouraged by a wider awareness within the financial community of the effects of the Connecticut Act, pressure exerted by the combined forces of consumer groups and small businessmen, greater competition among financiers,<sup>143</sup> and increased availability of FHA financing of home improvement loans.<sup>144</sup> As the effects of financier overreaction are mitigated, the reduction of fraud should weigh heavily in favor of the elimination of negotiability in consumer sales.

Even apart from these calculations, however, elimination of negotiability should be supported because of the distribution of costs it effects. Whereas with negotiable notes the buyer who chanced to contract with an unscrupulous salesman carried the whole burden of the risk of fraud, without such notes this burden is placed on financiers who have the economic power to spread the costs over the whole business. The slightly increased costs thus imposed on dealers and consumers who would not otherwise be forced to share them are necessary incidents of regulating the imperfections and injustices of the market.

## APPENDIX

### DEALER QUESTIONNAIRE

#### *ALL ANSWERS WILL BE KEPT IN STRICT CONFIDENCE*

Note: This study is not concerned with the consequences of the new Truth-in-Lending Bill. It focuses only on Connecticut P. A. 749, the Home Solicitation Sales Act. Please answer, in so far as possible, only with reference to the Home Solicitation Sales Act.

1. What is your main line of business? (For example, roofing, roofing and siding, swimming pools, etc.)
2. In what manner are your sales made? (Check approximate percentage of sales for each category.) (Percentage of number of sales)

	<u>100%</u>	<u>75%</u>	<u>50%</u>	<u>25%</u>	<u>0</u>
a. You or your employee(s) go door-to-door, find people who are interested in making purchases,					

143. See note 80 *supra*.

144. See note 34 *supra*.

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- and sign the contract at their homes. \_\_\_\_\_
- b. You or your employee(s) receive calls or visits from people interested in making purchases and you then visit them in their homes and sign the contracts there. \_\_\_\_\_
- c. You receive calls and visit homes, but sign the contracts at your place of business. \_\_\_\_\_
- d. People come to your place of business and the sale is concluded there without any visit to the customer's home. \_\_\_\_\_
3. Have the above percentages changed significantly since last October (the date the new Home Solicitation Sales Act went into effect)? Yes \_\_\_\_\_, No \_\_\_\_\_. If so, please indicate the pattern of sales prior to October 1967 marking the percentages as in question No. 2.
- |   | 100%  | 75%   | 50%   | 25%   | 0     |
|---|-------|-------|-------|-------|-------|
| a. You or your employee(s) go door-to-door, find people who are interested in making purchases, and sign the contract at their homes. _____                         | _____ | _____ | _____ | _____ | _____ |
| b. You or your employee(s) receive calls or visits from people interested in making purchases and you visit them in their homes and sign the contracts there. _____ | _____ | _____ | _____ | _____ | _____ |
| c. You receive calls and visit homes, but sign the contracts at your place of business. _____   | _____ | _____ | _____ | _____ | _____ |
| d. People come to your place of business and the sale is concluded there without any visit to the customer's home. _____  | _____ | _____ | _____ | _____ | _____ |
4. How many persons are involved in your business?
- a. Primarily a one-man business? \_\_\_\_\_
- b. One head of business and one full-time canvasser? \_\_\_\_\_
- c. Other (please specify, briefly)? \_\_\_\_\_
5. Has the number of persons in or structure of your business changed since last October? Yes \_\_\_\_\_, No \_\_\_\_\_. If so please describe briefly.
6. Have your sales or selling methods significantly changed since October 1967?
- a. Do you sell different products? Yes \_\_\_\_\_, No \_\_\_\_\_. If so, which?
- b. Do you sell different grades of the same products? Yes \_\_\_\_\_, No \_\_\_\_\_. If so, what briefly is the difference?



- c. Have the prices you charge customers changed since last October? Yes \_\_\_\_\_, No \_\_\_\_\_. If so, what is the approximate percentage change?
- d. Have you shifted sales away from the home in any way? Yes \_\_\_\_\_, No \_\_\_\_\_. If so, please describe.
- e. Do you sell to different types of customers? Yes \_\_\_\_\_, No \_\_\_\_\_. (For example, persons who are smaller credit risks.) If so, please describe.
- f. Other changes? Please describe briefly.
7. How many years have you been in this business? \_\_\_\_\_ How many years in this business in Connecticut? \_\_\_\_\_
8. Prior to the passage of the Home Solicitation Sales Act in July, 1967, did you use either banks or finance companies to help finance your customers' purchases? If so, did you use:
- Banks alone \_\_\_\_\_
  - Finance companies alone \_\_\_\_\_
  - Both banks and finance companies \_\_\_\_\_
  - How many financial institutions \_\_\_\_\_
- If you used neither, please briefly describe how the sales were financed.
9. Prior to the Act what percentage of your total sales were financed by credit? (Percentage of dollar amount.)
10. Since the Act what percentage of your total sales have been financed by credit? (Percentage of dollar amount.)
11. Arrangements with Financial Institutions prior to July, 1967. (Check to indicate what percentage of credit sales were made in each of the following manners.) (Percentage of number of credit sales.)
- |   | <u>100%</u> | <u>75%</u> | <u>50%</u> | <u>25%</u> | <u>0</u> |
|---|-------------|------------|------------|------------|----------|
| a. Bank or finance company purchase from you of the customer's note which you had accepted. | _____       | _____      | _____      | _____      | _____    |
| b. Direct loan from bank to customer on your recommendation.                                | _____       | _____      | _____      | _____      | _____    |
| c. Direct loan from bank to customer without your involvement.                              | _____       | _____      | _____      | _____      | _____    |
| d. Other (please specify).  | _____       | _____      | _____      | _____      | _____    |
- (Space is left here if you want to more fully describe the way your sales were financed. You are especially encouraged to comment if none of the alternatives listed above satisfactorily describes your financing system.)
12. Arrangements with Financial Institutions since October, 1967. (Check to indicate what percentage of credit sales were made in each of the following manners.)
- |   | <u>100%</u> | <u>75%</u> | <u>50%</u> | <u>25%</u> | <u>0</u> |
|---|-------------|------------|------------|------------|----------|
| a. Bank or finance company purchase from you of the customer's note which you had accepted. | _____       | _____      | _____      | _____      | _____    |

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- b. Direct loan from bank to customer on your recommendation.    \_\_\_\_\_
- c. Direct loan from bank to customer without your involvement.    \_\_\_\_\_
- d. Other. (If so, please describe.)    \_\_\_\_\_
13. Since the Act have any of the banks or finance companies with which you previously dealt refused: (This information, like all other answers in this questionnaire, will be kept in strict confidence.)
- a. To accept your paper? Yes \_\_\_\_\_, No \_\_\_\_\_.
- b. To give direct loans to customers recommended by you? Yes \_\_\_\_\_, No \_\_\_\_\_.
- c. Other refusals (please specify)? \_\_\_\_\_
14. If there were refusals:
- a. Which banks and finance companies were these? \_\_\_\_\_
- b. What were the alleged reasons for the refusal? \_\_\_\_\_
15. Is it more difficult to obtain financing now than in July 1967? Yes \_\_\_\_\_, No \_\_\_\_\_. If so please explain. \_\_\_\_\_
16. a. What interest rate do your customers pay to obtain their credit? Give an average loan amount \_\_\_\_\_ and an average loan term \_\_\_\_\_ along with the interest rate \_\_\_\_\_.
- b. Has this interest rate gone up since August 1967? If so, on the same average loan and term, what was the rate then? \_\_\_\_\_
- c. Do you now have to post bonds? Yes \_\_\_\_\_, No \_\_\_\_\_, or accept reserves, Yes \_\_\_\_\_, No \_\_\_\_\_, in the bank(s) with which you deal? If so, what are the terms? \_\_\_\_\_
- d. Did you have to engage in either of these practices prior to the Act? Yes \_\_\_\_\_, No \_\_\_\_\_. If so what were the terms then? \_\_\_\_\_
- e. Do you now receive "incentive payments" (a percentage of the interest on the sale—sometimes referred to as "kickbacks") from the banks or finance companies with which you deal? Yes \_\_\_\_\_, No \_\_\_\_\_. How much is this (express by percentage)? \_\_\_\_\_
- f. Did you receive such "incentive payments" prior to the Act? Yes \_\_\_\_\_, No \_\_\_\_\_. If so what were the terms then? \_\_\_\_\_
- g. Do any financial institutions with which you deal take more than the interest rates—that is, require that you pay them part of the sales price? Yes \_\_\_\_\_, No \_\_\_\_\_. If so, what were the terms then? \_\_\_\_\_
- h. Did the financial institutions with which you deal do this \_\_\_\_\_ take part of the sales price \_\_\_\_\_ prior to the Act? Yes \_\_\_\_\_, No \_\_\_\_\_. If so what were the terms then? \_\_\_\_\_
17. Have the banks or finance companies with whom you deal adopted new screening procedures since July 1967? Yes \_\_\_\_\_, No \_\_\_\_\_. If so, please check the one of the following categories which best describes your attitude toward the new practices.
- a. They were no trouble for you and you accepted them. \_\_\_\_\_
- b. They were a nuisance but you accepted them. \_\_\_\_\_
- c. Because they were a nuisance, you didn't wish to and therefore did not comply with them. \_\_\_\_\_. On refusing to comply you had to stop doing business with that financial institution \_\_\_\_\_.

d. They were so tough that you could not comply with them. \_\_\_\_  
This forced you to stop doing business with that institution. \_\_\_\_  
18. Do you think that any or almost any dealer, reputable or not, could obtain financing from a bank or finance company before the Act? Yes \_\_\_\_, No \_\_\_\_.

Has that situation changed now? Yes \_\_\_\_, No \_\_\_\_\_. If so, please briefly describe.

19. Do you know of any banks or finance companies which before the Act would finance practically anyone? Yes \_\_\_\_, No \_\_\_\_\_. Which banks or finance companies?

20. Do you know of anyone who has had to go out of business altogether since October 1967, because of inability to obtain financing? Yes \_\_\_\_, No \_\_\_\_\_. If so, how many? \_\_\_\_ What are their names and where do they live?

21. Can you obtain notes from banks which don't have "Home Solicitation Sales" written on them? Yes \_\_\_\_, No \_\_\_\_\_. If so, when do you use the paper without "Home Solicitation Sales" marked on it?

22. a. In order to obtain financing, do you have to agree with the bank to repurchase any commercial paper when a customer claims he doesn't have to pay? Yes \_\_\_\_, No \_\_\_\_\_. Has this change since October 1967? Yes \_\_\_\_, No \_\_\_\_\_. If so, how?

b. Do you have to guarantee a certain number of payments from your customers? Yes \_\_\_\_, No \_\_\_\_\_. Has this changed since October 1967? Yes \_\_\_\_, No \_\_\_\_\_. If so, how?

23. Do you think it is a good policy to force banks to have greater responsibility for home solicitation sales? Yes \_\_\_\_, No \_\_\_\_\_. Please explain briefly your answer.

24. Do you think that dealers before July 1967 used practices which were unfair to customers? Yes \_\_\_\_, No \_\_\_\_\_. (Don't include in your consideration the problem of informing customers about bank interest rates.)

Most dealers \_\_\_\_ Many dealers \_\_\_\_ Some dealers \_\_\_\_ Very few dealers \_\_\_\_ No dealers at all \_\_\_\_

Would you estimate that these practices have changed since July 1967? Yes \_\_\_\_, No \_\_\_\_\_. If so, how?

25. Please list a few of the practices which you consider to be unfair.

26. Have any of your customers used the new "cooling-off period" provided by the statute to cancel purchases within the next business day after they were made? Yes \_\_\_\_, No \_\_\_\_.

a. If so, how many? \_\_\_\_ Did you collect the penalty? Yes \_\_\_\_, No \_\_\_\_\_. What were the alleged reasons for the cancellations?

b. Do you inform your customers at the time of making a sale of their right to cancel within the "cooling-off period?" Yes \_\_\_\_, No \_\_\_\_.

27. Prior to October 1967, did you as a matter of business practice, allow customers to cancel sales already concluded?

a. As long as you hadn't already begun work on the job? \_\_\_\_

b. Within a day? \_\_\_\_

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- If so, did you charge a penalty? \_\_\_\_\_
28. What was the approximate dollar volume of your business in:
- |            |      |       |           |      |       |
|------------|------|-------|-----------|------|-------|
|            | 1966 | _____ | Oct.-Dec. | 1967 | _____ |
| Oct.-Dec.  | 1966 | _____ | Jan.-Mar. | 1968 | _____ |
| Jan.-Mar.  | 1967 | _____ | Apr.-June | 1968 | _____ |
| Apr.-June  | 1967 | _____ | July      | 1967 | _____ |
| July-Sept. | 1967 | _____ | July      | 1968 | _____ |
29. How many sales did you make in 1966? \_\_\_\_\_
- How many sales did you make in 1967? \_\_\_\_\_
- How many sales do you estimate you will make in 1968? \_\_\_\_\_

*ALL ANSWERS WILL BE KEPT IN STRICT CONFIDENCE*